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Managing the Overall Business

Part II in the **6** part series:

Business Management for Farmers

NCR 610B

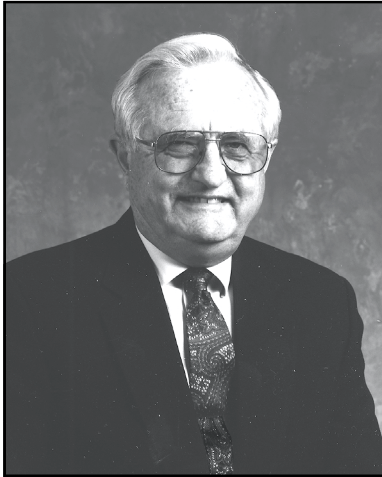
Managing the Overall Business

Part II in the **6** part series:

Business Management for Farmers

Kenneth H. Thomas
Professor Emeritus and former Extension Economist, Farm Management
University of Minnesota

MWPS
MidWest Plan Service
122 Davidson Hall, ISU
Ames, IA 50011-3080



About the author

Kenneth H. Thomas was an extension economist in Farm Management at the University of Minnesota from 1959 to 1992. That this was a very dynamic period in U.S. agriculture is reflected in the wide range of management issues he worked on and wrote about.

During the 1960s and early 1970s he was very involved in helping farm families develop longer range plans for their businesses. In 1973, he coauthored a North Central Region publication that integrated profitability and financial soundness aspects into business planning and analysis.

Beginning in the mid-1970s he began working in and writing about land rental arrangements and the buying and selling of farmland. He also began working in the areas of getting started in farming, business arrangements, and farm estate planning and transfers, coauthoring four regional bulletins on these topics.

As businesses became larger, he began working on personnel management issues and coauthored a regional bulletin on farm personnel management. He also team-taught an agricultural law course at the University of Minnesota, which led to the inclusion of a number of the legal aspects in this series.

As a capstone of his career and as a transition into retirement, he began writing this six-part series, *Business Management for Farmers*. It is his hope that this six year "labor of love" will prove helpful to present and future generations of farmers.

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Preface

It's much easier to mix business with pleasure than business with profit. –*Unknown*

The farm manager's job—a perspective

Managing a modern farm business is a complex task, Table 1. The following is a brief description of the various dimensions of a farm manager's tasks.

Management functions. Like other business managers, farm managers must carry out four major functions:

- Planning.
- Organizing.
- Implementing and directing.
- Monitoring and adjusting the business as needed.

Areas of responsibilities. A farm manager is likely to have responsibilities in five broad areas:

- Production.
- Marketing.
- Finance.
- Personnel and family relationships.
- Overall business and legal areas.

These areas of management responsibility have broadened dramatically in the past 30 years, from a time that involved primarily a production-oriented management focus, to the present situation in which few businesses can be successfully operated without some attention being given to each of these five areas.

Carrying out these functions has become increasingly complex as farm businesses have become larger and more market-oriented on both the input and output sides.

Goals and mission. A farm manager does not carry out these functions and responsibilities in a vacuum. Therefore, the third piece of the management puzzle is to establish realistic, attainable business goals, that are also compatible with the owner/manager's other goals, and those of the other affected parties. These other parties may include:

- A spouse and other family members.
- Other partners or shareholders.
- Employees.
- Resource suppliers.
- Consumers and society at large.

This six-part series is designed to address each of these dimensions so that a manager can better execute his/her many responsibilities.

About the rest of the series

This publication is the second in a planned six-part series written for and dedicated to farm operators and managers in the U.S. Parts I, II, III and IV deal with managing an established farm business. Part V focuses on the issue of getting established in farming, while Part VI deals with planning the late career/retirement years. The series should prove useful not only to managers, but to educators, lenders, consultants and others, including persons considering farming as a career. **A list of chapter headings for parts I, and III-VI is on the inside back cover of this publication.**

Part I, *Developing a Longer Range Strategic Farm Business Plan*, first provides an introduction to the planning process. It then covers evaluating a present business situation and setting tentative lifestyle and business goals. This is followed by a discussion of the development of a longer range business plan. Information is then provided on how to develop, gain acceptance of, and implement a workable transition plan. Restructuring and/or liquidation of a financially stressed farm business are also addressed.

Part II, this part, focuses on the on-going management of the overall business. Within Section I, *People Skills and Legal Aspects*, Chapter 1 discusses evaluating and improving communication and negotiation skills. Chapter 2 focuses on legal aspects including contracts and property law–two legal aspects that tend to permeate the management of a business. It also contains a guide to where various other legal aspects are discussed throughout this series.

In Section II, *Financial Management of a Business*, Chapter 3 focuses on developing, implementing and controlling annual financial plans. Chapter 4 covers the financing of non-real estate aspects of a business. Chapter 5 deals with income tax planning and management issues, while Chapter 6 discusses the use of insurance in managing business- and family-related risks.

Section III focuses on business arrangement and retirement and estate planning issues. Chapter 7 deals with developing and updating farm business arrangements. Special emphasis is placed on the formation,

Table 1. The farm manager's job—a perspective.

Management functions	Areas of responsibility	Goals/mission
▪ **Planning** Evaluate present business/situation Identify and analyze alternative changes Decide/finalize the plan ▪ **Organizing** Lease and contract agreements Acquire funds/security agreements Risk management options Staffing/employee agreements Develop a monitoring/control system Form of business organization/ agreements Update estate plans ▪ **Implementing and directing** Activate/manage production systems Manage the work force Follow markets/make decisions Keep lenders, landlords, and others informed ▪ **Monitoring and adjusting** Keep appropriate records Periodically compare results with plan Make needed adjustments	▪ **Technical/production** What to produce How to produce it How much to produce ▪ **Commercial/marketing** Acquire inputs Market products Forecast prices/costs ▪ **Financial** Acquire/manage funds Manage risks Estate planning/transfer ▪ **Personnel/family** Manage the present work force Personnel planning/hiring Labor laws and regulations ▪ **Overall business/legal** Business/legal aspects Business environment aspects Business arrangements Law & regulation changes	**Owner/manager goals** ▪ **Business related goals** Improve profitability Improve financial soundness Manage a larger/smaller business Reduce business/financial risks Transfer business ▪ **Other goals** Increase family living Increase leisure time Community service **Other affected parties' goals** ▪ **Spouse (if any)** ▪ **Family** ▪ **Other partners/shareholders** ▪ **Employees** ▪ **Lenders** ▪ **Landlords** ▪ **Consumers/society**

operation and reorganization or liquidation of a farm coporation and on estate planning issues. Chapter 8 addresses making a mid career check of retirement plans.

Part III, *Managing Crop and Livestock Systems,* discusses production and marketing aspects and the use of production contracts. Part IV, *Acquiring and Managing Resources*, focuses on the acquisition of land via lease and purchase; the management of machinery systems; and personnel planning and management.

Part V, *Getting Established In Farming*, discusses whether one should consider farming as a career, whether to farm together; starting farming via multi-owner-operator route or partly or mostly on one's own. Part VI, *Planning the Late-Career, Retirement Years*, focuses on lifestyle planning, financial security aspects and the transfer of farm assets.

Acknowledgments

Part II addresses a wide range of management issues. The author is indebted to a number of people for their help in its development and review. Several are noted in selected chapters as appropriate.

Special thanks are extended to:

- Paul Brutlag, attorney/farm operator of Elbow Lake, MN for his helpful suggestions in the development of Chapters 2, 4, 6, and 7, which contain important legal, as well as business management, information.

- Richard O. Hawkins, Professor Emeritus, University of Minnesota, for his review and suggestions for all parts of the series. Thanks also to the Center for Farm Financial Management at the University of Minnesota for providing secretarial support for this project.

Finally, the author wishes to thank the North Central Farm Management Extension Committee for their support of this series. Thanks also to the staff at MidWest Plan Service for their expertise in the editing and designing of this publication.

Section I

People skills and legal aspects

Evaluating and improving people skills[1]

1

- Effective communication
- Effective negotiation

Managing a farm business today requires that farm managers interact with an ever increasing number of people. These people may include family members, business partners, employees, landlords, suppliers, lenders, buyers, government agencies, accountants, lawyers.... The list just keeps getting longer and longer.

To effectively manage an on-going business, a manager must have a number of "people" skills that can be used with a reasonable level of proficiency. This chapter focuses on two of these skills: communication and negotiation. The discussion of each skill is quite brief but should increase awareness of the nature and importance of each of these skills as well as suggest ways to improve effectiveness in each of these areas.

Effective communication

At the very heart of developing and maintaining interaction with people is the ability to communicate effectively. This segment first describes the basic elements of the communication process. It then outlines a procedure for evaluating one's present communication skills. It closes with some suggestions regarding the development and maintenance of an effective communications system for a business.

Understanding the communication process; opportunities for improvement

The basic elements involved in the communication process are shown in Figure 1-1.

On the face of it, it appears that to improve communications the options are: (1) send clearer, more understandable messages; and/or (2) use a different channel or method of sending the message. But, the two key elements in the communication are: (1) understanding the people involved (namely, the sender and receiver), and (2) choosing the type of persuasion to be used.

1. Special thanks to:
Dr. Sharon M. Danes, Professor, Family Social Science, University of Minnesota, for her help in developing the communication section and review of this chapter.
Dr. Ward E. Nefstead, Extension Economist, Marketing, University of Minnesota, for his helpful comments on this chapter.

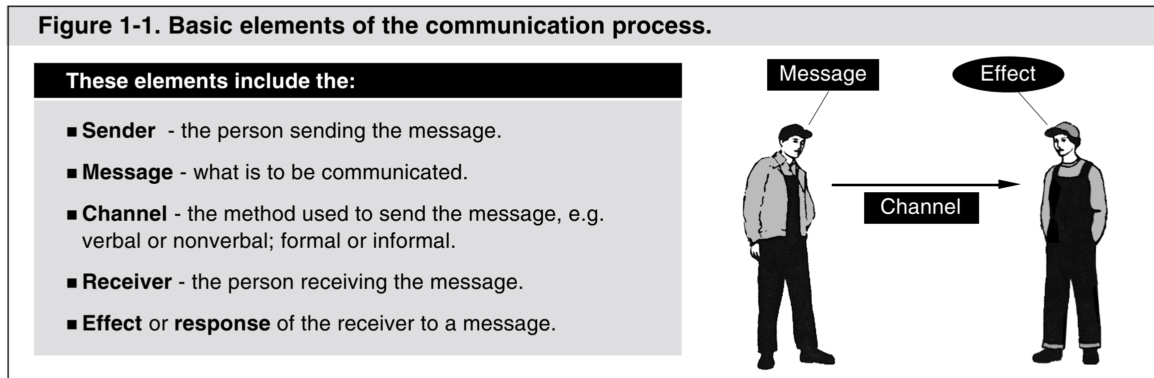


Figure 1-1. Basic elements of the communication process.

Understanding the receiver

As a manager increases his/her knowledge and understanding of employees and business associates as individuals, the more able he/she will be at sending appropriate messages and therefore achieving the desired response.

Every person wants to be considered a valuable, accepted, contributing human being. But, every human being is "programmed" differently. Past experiences with members of the business, as well as others, are part of this programming. Therefore, get to know employees as individuals, i.e. personality, values, skill level, past experiences. It is also important to know what that individual's present situation is like — "walking in their shoes for awhile," so to speak. A better understanding of the receiver produces empathy for him/her; therefore, messages will be more appropriate, and the receiver is more likely to respond favorably. Understanding involves more than just knowing a person's skill level or past experience. It involves knowing an individual's unique perspectives.

Deciding whether to use direct or indirect persuasion

The communication process depicted in Figure 1-1 represents a one-way, **direct persuasion** approach to communication. Such an approach focuses on structure, power, and telling others what to do. By using this approach, a manager essentially takes responsibility for decisions and actions, and for the results.

At the other extreme is **indirect persuasion**. This approach centers on the needs, wishes, and desires of others. The **other person** is responsible for implementing his/her own decisions. A manager can help explore ideas, facts, feelings, but the person will make the decision and carry it out.

Whether to use the direct or indirect method of persuasion, Table 1-1, (or something in between) is best handled on a case-by-case, or situation, basis. Regardless of the exact approach used, the important point is that communication should, in most cases, be a two way street, **with messages being sent both ways**. The receiver should be able to send "feed back" messages which may involve clarification and suggestions. If this more fluid approach is used, the original sender must also become a **good listener**. A good listener is an **active** listener in that a response is required. Either:

- Change or rescind the original message.
- Change the channel or method used to send the message.
- Reaffirm the original message.

Evaluating present communication skills; selecting ways to improve

Worksheet 1-2 contains a list of characteristics of good communication, or what needs to happen for good communication to occur. Managers should review these nine items and rate the present level of their communication. Managers may also want spouses or other members of their family and farm team to rate *the manager's* present communication skills. This approach does involve some risks. But if one is serious about improving communication skills, feedback from others is essential.

Once a rating for individual items is given, assign an overall rating as a communicator. Then list some possible steps to take to improve both personal communication skills and the communication process within the family and business.

Developing and maintaining an effective communications system

Another important aspect of the communications process is the development and maintenance of an effective communication system for a situation. This system should focus on two different groups: (1) within the family and business complex (internal), and (2) communications with outside parties (external).

Communication within the family/business complex (internal)

Within the family/business complex, communications can be handled in several ways including daily personal contact, group meetings, and through the use of other communication methods.

- **Daily personal contacts.** In the words of Harvey Mackay[2], Minnesota business man and author, "you'll always get the good news; it's how quickly you get the bad news that counts." Mackay has an iron clad rule for himself: **he walks his plant every day**. "I can learn something new and get the feel, touch, and pulse of the place without anyone having to say a single word to me," Mackay says.

  Thus, a manager should have in place a plan or method for having personal contact with workers each day, and **on their turf**. It will not only build an understanding of each worker, but it will reinforce the fact that what they are doing is important, and that it should be done right. Have a job description in place for each worker or small group of workers, and use this job description to serve as an agenda for discussion. These sessions can be informal, but structured, always focusing on the job or task, **not on the person**. Determine together whether a problem exists and how it can be solved. Both should commit to the solution and check back to see about results.

  Make contact with selected workers at the end of the work day to determine what was accomplished and what has been left undone. Also have contact with spouse or other family members to keep both family and business communications open.

- **Group meetings**. Group meetings are essential to develop a feeling of the big picture, or vision of the business, and to foster a team effort. Such meetings should involve the "right" people or players to address the issues or agenda items that pertain to them.

  Each meeting should be well planned and focused, and there needs to be a high level of trust, faith in, and respect for each member present. The main purposes of these types of meetings are to:

  a. Create new information.
  b. Educate.
  c. Arrive at the commitment necessary for the group to solve problems or to maintain their commitment to an already high level of performance.

- **Use of other communication methods as applicable**. Not all communication within the family/business complex needs to be done in person. Depending on the situation, other methods might include memos, clipboards, posters, or videos. Time is valuable, so use these other methods when appropriate.

Table 1-1. Characteristics of direct and indirect persuasion.

Direct	Indirect
Self-centered	Others-centered
Power and authority	Ideas and feelings
Telling behavior	Asking questions and listening
Imposing decisions	Developing decisions
Persuader is responsible	Other person is responsible

2. Harvey Mackay, *Swim With The Sharks Without Being Eaten Alive*, Ballentine Books, 1988, p. 137.

Communication with outside parties

Farm managers also must maintain communication with resource suppliers, such as lenders, landlords, farm input suppliers, and with purchasers of their products as well as with marketing specialists. They also must maintain communication with service-related parties such as attorneys, accountants, and veterinarians. Therefore develop a communication plan for these types of entities as well.

Effective negotiation

Like it or not, a manager is a negotiator. In managing a modern farm business, there is a constant process of negotiation, whether it be the purchase of a farm, borrowing money, buying production inputs, marketing a crop, managing employees, or interacting with family members or business partners.

Getting to yes: A manager's negotiating options

What is the best way for people to negotiate their differences? Basically, negotiation involves back-and-forth communication designed to reach an agreement on something that is at issue, whether it be a conflict situation involving two or more people, or the purchase price of a combine. Managers often find themselves in a dilemma: "What negotiating approach should be used in this situation?"

Options 1 and 2: Playing hard ball or using the soft approach

Often, managers think that a successful negotiation involves playing "hard ball". Fisher and Ury[3] describe this approach: "The **hard** negotiator sees any situation as a contest of wills in which the side that takes the more extreme position and holds out the longest fares better." They add, "He/she wants to win; yet he/she often ends up producing an equally hard response, which exhausts him/her and their resources and harms his/her relationship with the other side." This is often thought of as the "I win, you lose" syndrome. In a business setting, the "hard ball" approach may be useful only when dealing with competitors or persons/businesses with whom a manager may deal only on rare occasions.

At the other extreme is the "**soft**" negotiating approach. The "soft" negotiator wants to avoid personal conflict, and as a result readily makes concessions in order to reach agreement. In stark contrast to the "hard ball" negotiator, the "soft" negotiator is bent on finding an amicable resolution. Yet, he/she often ends up being exploited and feeling bitter. This can best be described as "I lose, you win."

Of course, there are a number of negotiating strategies that fall between these hard and soft negotiating approaches. But, each of these approaches involves an attempted trade-off between getting what one wants (being assertive/confrontive) and getting along with people (being cooperative). For more on this, see Figure 1-2 and related discussion.

Option 3: Using the principled negotiation approach

But, Fisher and Ury point out that, in negotiation, the destination isn't as important as the process of getting there. Thus, they advocate an approach called **principled negotiation**. With this approach one **decides issues on their merits** rather than through a haggling process, focused on what each side says it will or won't do (positioning). "Principled negotiation suggests that you look for mutual gains wherever possible, and that where your interests conflict, you should insist that the result be based on some fair set of standards, independent of either sides' positioning." [4]

They describe it as follows: "The method of principled negotiation is hard on the merits of the case, while being soft on people.

3. Roger Fisher, and William Ury, *Getting To Yes: Negotiating Agreement Without Giving In*, Penguin Books, USA, Inc., Second Edition, 1991, p. xviii.

4. Fisher and Ury, p. xviii.

It employs no tricks and no posturing. Principled negotiation shows one how to obtain what one is **entitled** to (not what one wants) and still be decent to the people involved. **It enables one to be fair, while protecting oneself against those who would take advantage of one's fairness" (emphasis added).**[5]

Thus, under principled negotiation, the participants become problem solvers, and the goal is a wise outcome reached efficiently and amicably. There are four keys to making this negotiation approach work:[6]

1. **Separate the problem from the people**. Negotiators should be soft on people and hard on the problem. And, the process should be independent of the negotiators' degree of trust in each other.
2. **Focus on interests not "positions" of the parties involved**. Explore the interests of the parties involved and avoid having a bottom line–at least early on.
3. **Invent options that would result in mutual gain (win-win)**. This should involve developing multiple options and exploring them. Then, and only then, should a decision be made.
4. **Insist on using criteria when trying to make a decision**. This involves trying to reach a result based on standards independent of the negotiating party's strength of will. **Yield to principle not pressure**.

Applying principled negotiation to the farm business/family situations

As noted at the outset, using a so-called "hard ball" negotiating strategy may provide for short-term gain. But a manager needs to also consider relationships over the long haul. Getting another party to say yes only after they have been brought "kicking and screaming" to one's point of view makes the longer-term potential of the relationship questionable at best. This is particularly true in the typical farm family/business situation, where the parties are usually related or known on a first name basis. This includes not only one's immediate family members and employees, but lenders, landlords and suppliers to name a few.

By the same token, one who decides to use a "soft" negotiating style (reaching agreement largely by defaulting) is not likely to be very happy being essentially "a loser" over the long haul. One who uses this negotiating style by choice will have only self to blame. But, if a soft style is forced upon someone, e.g. by a parent onto a child, then things have to change, or the association will be strained or possibly broken.

Thus, the **principled** negotiation approach is an ideal one in the typical farm business/family situation, whether the issue is business or conflict resolution between family members or employees. But, people problems are often the most difficult to resolve, and if they are not resolved in a timely, fair manner, the resulting debris from the explosion may last for years, particularly if it involves family members.

The following discussion focuses on the process of negotiating and mediating people problems within a business. First, a model presents the range of behavior patterns that might typically be encountered and the resultant conflict outcomes. This is followed by a discussion of the use of the principled negotiation approach, and provides techniques for evaluating one's present ability in managing conflict.

Behavior patterns and resultant conflict outcomes

It is important for a manager to first understand that, when two or more people are involved, some conflict is normal. It can result from:

- A lack of communication or unresolved prior conflicts.
- Differences in values, goals and expectations of the parties involved.
- Role conflicts and conflicts resulting from differences in status within the business, the family, or society.
- Scarcity of resources, which may result in people being overworked or poorly paid, or conflicts arising from inadequate capital, or equipment.

5. Fisher & Ury, p.xviii.
6. Fisher & Ury, pp. 10 and 11.

- Personality differences that do not mesh well.
- Perceived differences regarding the situation.

Figure 1-2[7] illustrates the broad range of possible behavior patterns of people and the resultant outcomes when these behavior patterns are combined in various ways.

Behavior patterns/two basic variables

The model below suggests that there are two types of behavior that may occur when two or more people interact with each other, and that each can occur in varying degrees. **Self-oriented** behavior relates to the person's self-assertiveness or the extent to which an individual attempts to satisfy his/her own desires, to the exclusion of others. The degree of self-assertive behavior can range from **unassertive** or **avoidant** to the very **assertive**, highly **confrontive** behavior.

The contrasting behavior is the extent to which an individual is **other person-oriented** (as contrasted to the self-oriented behavior described above). But again, the degree to which a person is **other person-oriented** can range from being **very uncooperative** to that of being **very cooperative**.

Resultant outcomes

Figure 1-2 shows that when two or more people are in conflict, there are five general outcomes that can occur:

1. If the parties involved are both **unassertive** and **uncooperative**, they will likely end up with a **conflict avoidant** situation, and a likely **lose-lose** situation.
2. If one of the parties involved is **uncooperative** and highly **self-assertive**, they will likely experience a very **competitive win-lose** outcome.
3. At the other extreme, if one of the parties is **unassertive** yet very **cooperative**, expect an accommodative outcome, resulting in a **lose-win** situation for the unassertive person.
4. If the parties involved are **assertive** yet very **cooperative**, expect a **collaborative**, **win-win** outcome, which is the most highly prized of conflict outcomes.
5. Another possible outcome is one focused on compromise, with no winners or losers evident. This **no-loser/no-winner** situation clearly can be described as a **draw**.

7. Adapted from: Kenneth W. Thomas, *Conflict and Conflict Management,* in the *Handbook of Industrial and Organizational Psychology*, Marvin D. Dunnets, ed. Chicago, IL. Rand McNally, 1983.

Figure 1-2. Alternative negotiating stances and resultant outcomes - a model.

	Uncooperative Unreasonable	**Other Person-Oriented Behavior**	Cooperative Reasonable (Soft Approach)
Assertive/ Confrontive (Hard Approach)	Competitive Win-lose		Collaborative Win-win
Self-Oriented Behavior		Compromising No Winner No Loser (A Draw)	
Unassertive/ Avoidant	Avoidant Lose-lose		Accommodating Lose-win

Managing conflict using the principled negotiation approach[8]

Good working relationships with business associates and family members require that conflicts be addressed and hopefully resolved with a **win-win** or **no-winner/no-loser outcome**. These desired outcomes may not be possible in all conflict situations, but that should be a manager's goal. To help with this process, an outline of the steps involved in managing conflict is provided, followed by some guidelines for fostering smooth, productive discussions in the conflict management process. Note that the process laid out involves the principled negotiation approach discussed earlier in this segment.

Steps in the conflict management process

There are six basic steps in the conflict management process:

1. Clarify each person's view of the problem.
2. Make a commitment to work on the problem/resolve the conflict.
3. State respective personal needs or concerns.
4. Be creative in finding/considering alternative solutions.
5. Select a solution.
6. Set a time to review the situation to determine if the agreed upon solution is achieving the desired outcome.

Some guidelines for fostering resultant, productive management of a conflict situation

Worksheet 1-1 gives some guidelines to be followed in conflict management sessions. The manager should assess how well and how often he/she follows these guidelines.

If most of the answers to the statements are *always* or *often*, then the principled negotiation approach is in action. If responses tend to fall into the *sometimes* or *never* categories, then win-lose or lose-win solutions to conflict situations are more likely to occur. To improve on these latter solutions, focus on each of the items listed below, to change *sometimes* or *never* responses to *always* or *often* responses.

Evaluating one's present ability to manage conflict

With the above as background, a manager can evaluate his/her present ability to manage conflict, and list ways to improve conflict management skills. There are three approaches to follow in evaluating present conflict management skills:

1. By returning to Figure 1-2: Which category tends to describe the present approach to dealing with conflict? Place an X by the intended result in conflict situations. Next place a ✓ by the usual result.
2. For each of the guidelines noted above, indicate the extent to which each item is followed using such terms as always, quite often, sometimes, and never, Worksheet 1-1.
3. Use Worksheet 1-3 to provide another measure of conflict management skill. Use it as a checklist after actually resolving a recent conflict.

Worksheet 1-1. Self-assessment of negotiation style.

(Always, often, sometimes, or never)

____________________	I allow free expression of ideas without making judgments.
____________________	I focus on the issues, not on the personalities involved.
____________________	I listen with empathy and without interruption or distraction.
____________________	I speak clearly and directly.
____________________	I respect differing points of view.
____________________	I am willing to spend the time that true conflict resolution often requires.

8. The term *conflict management* is used in place of *conflict resolution* because conflict in family businesses is usually very hard to totally resolve, and conflict resolution assumes the elimination of an opposing party or position. Most times that is neither possible nor productive in a family business.

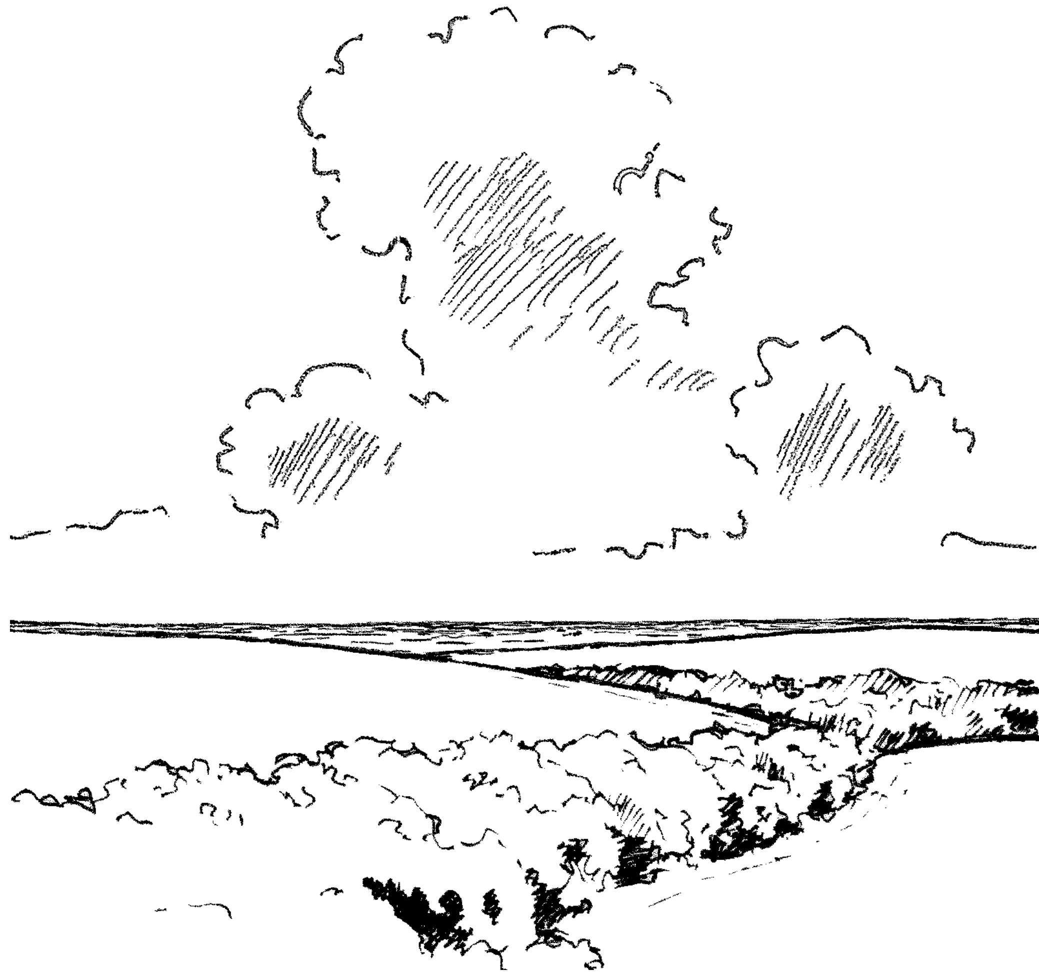
Negotiating through three difficult situations–a brief note

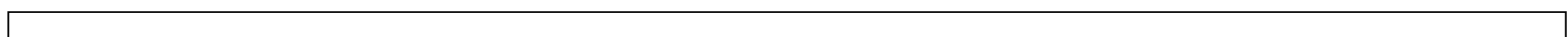
The principled negotiation approach— talking about interests, options and standards— is most effective if the parties involved have:

- About the same bargaining strength or position.
- A willingness to play the negotiating game.
- An intention to negotiate fairly and in good faith.

But, as Fisher and Ury[9] point out, the world is full of imperfect people and situations. Thus, they offer insights and strategies that might be used in situations where the above three conditions are not present. Because of the importance of being an effective, fair negotiator in today's business world, a copy of *Getting to Yes: Negotiating Agreement Without Giving In* will be a handy reference guide when negotiating in difficult situations as they arise.

9. Fisler and Ury, p. 97.





Worksheet 1-2. Evaluating present communication skills; identifying possible changes.[10]

The following is a list of characteristics of, or items involved in good communication. Rate present communication skills for each item as ***very good***, ***pretty good***, ***fair*****,** or ***poor***.

My communication:

______________________ is personal, focused, contains a *clear message*, and is related to the interests and needs of the person with whom I am speaking.

______________________ includes *feed back* which involves answering questions and repeating information to be sure we understand each other.

______________________ is well *timed* and *considerate* of others and doesn't embarrass the other person(s) in front of others.

______________________ incorporates flexible rather than rigid *behavior expectations* (response).

______________________ involves *giving full attention to the person* with whom I am speaking, by maintaining eye contact and a relaxed non-judgmental body language.

______________________ may include *listening for strong feelings* and expressing my own feelings. (You can't talk about facts or important issues if a person holds back strong feelings.)

______________________ *avoids loaded questions* and uses open (what, how), rather than closed questions (yes, no). (Open questions encourage the expression of feelings, opinions or beliefs. "Why" questions may cause people to be defensive.)

______________________ involves *active listening*—giving and receiving verbal and nonverbal feedback versus *passive listening* where I do not respond, am judgmental, and/or appear disinterested.

______________________ involves *influencing* the direction of the conversation, rather than *controlling* the discussion.

- After rating yourself on *each* of the above items, give yourself an *overall* rating as a communicator:

___________very good; __________ pretty good; __________fair; __________ poor.

- List some steps you plan to take to become a better communicator.

____

____

____

____

____

____

____

____

10. Source: Marion M. Anderson, S.M. Danes, M.L. Freeman, G.A. Hachfeld, M.L. Harder, J.K. Sprain, K.H. Thomas, *Managing Our Farm Family Future*, University of Minnesota Extension, St. Paul, MN., 1988, *Chapter 4, Strengthening The Farm Family Through Communication and Decision-making by S.M. Danes*.

Worksheet 1-3. How Well Did You Fare In Using The Conflict Management Process?[11]

Try working through the conflict management process with a current conflict problem. After doing so, check a yes or a no for each question. The more yeses you are able to check, the more effective you are becoming in the conflict management process. Consider also how you can improve on the areas where you answered no.

	Yes	No
1. Did you define the problem adequately?	______	______
2. Did you allow for innovative alternatives in brainstorming without analyzing them?	______	______
3. Did you handle emotions first before anything else was done?	______	______
4. Did you allow time for everyone to be heard before arriving at a solution?	______	______
5. Did you discover the hidden agendas or needs?	______	______
6. Did you recycle the process when it didn't work the first time?	______	______
7. After going through the process, did you work out the nitty gritty details?	______	______
8. Did you follow-up to see that the action steps were working?	______	______
9. Did you have enough faith that the conflict would be resolved constructively?	______	______
10. Did you view conflict as a constructive opportunity for positive change?	______	______

- Indicate changes to make to improve your conflict management skills:

____

____

____

____

____

____

____

____

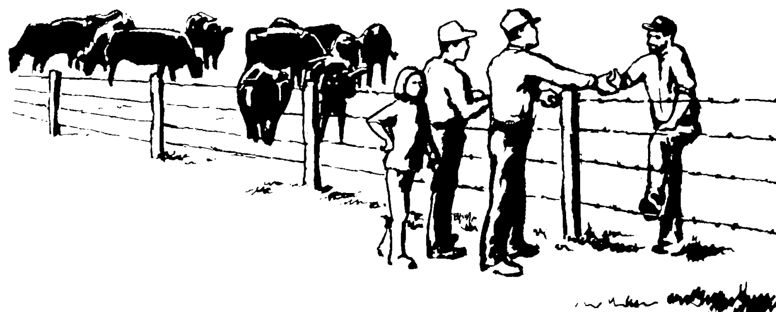
____

11. Adapted by Sharon M. Danes, Professor, Family Social Science, University of Minnesota, and Family Resource Management Specialist, Minnesota Extension Service from *Social Decision Making* by Kathryn D. Retting, Family Social Science, University of Minnesota, 1986.

Contracts and property law; a guide to other legal aspects[1]

2

- General principles of contract law
- General principles of property law
- A guide to other legal aspects



Disclaimer clause:

The general approach of this series is to flag legal issues that may be encountered in planning and managing a business. Discussion of these issues is not intended as a substitute for the services of an attorney well versed in these farm-related legal matters. The series is intended to help identify the need for appropriate and timely legal advice. Remember, attorneys make a lot more money from fixing people's mistakes than from providing preventive legal planning.

Laws and regulations affect a farm business at many points. This chapter first discusses in some detail: (1) the principles of contract law, and (2) the rights, restrictions, and responsibilities in owning and using farm property. It then discusses briefly several other areas of law that a farm manager must be aware of and indicates where these various legal aspects are applied in this and other parts of the series.

General principles of contract law

Farm managers make many different types of contracts each year. In this segment, the general principles of contract law are discussed, including:

- The essential elements of a contract.
- When a contract must be in writing.
- When performance of a contract may be excused.
- Possible remedies for breach of contract.

Essential Elements of a Contract

A contract is an agreement between two parties in which both parties are legally obligated to perform, and for which either can go to court and receive some type of relief if the other party does not meet contractual obligations.

Five elements must be present before the legal duty to perform arises. They include:

1. **Legally competent parties.** The parties involved must be of legal age, (generally 18 years of age or older) and be mentally competent before they can be bound by the terms of a contract.

2. **Legal and proper subject matter.** The subject matter with which the contract deals must be both legal and proper. That is, the *performance* required must be legal

1. For legal reference, consider obtaining:
Agricultural Law, Principles and Cases by J. W. Looney and Donald L. Uchtman, McGraw-Hill, Inc. 1994.
Agricultural Law Manual by Neil E. Harl, Agricultural Law Press, Eugene, OR. 1985.

(a legal act); the *agreement* must be legal; and the agreement must be consistent with public policy (one party must not take advantage of another).

3. **An offer must be made.** An offer is a promise which is conditional upon the other party:

- Doing some act.
- Intentionally not doing some act.
- Promising of some return performance.

4. **Acceptance of the offer.** Once an offer has been made, it is essential that the other party accept the offer in order to create a contract.

5. **Consideration.** The final essential element of a contract is consideration. Consideration must be legally sufficient. That is, the parties to the contract must exchange something of value.

When a contract must be in writing; some exceptions

Certain types of contracts are required to be in writing to prevent fraud. Here, four types of contracts that must be in writing are discussed; then note is made of some exceptions to this requirement.

Types of contracts required to be in writing include:

1. **Contracts taking more than one year to perform.** Contracts must always be in writing to be enforceable if they will not *be fully* performed within one year. It is important to know that the one year period is measured from the *date of the agreement*, rather than the date that performance is to start.

2. **Contracts involving the transfer of farm real estate.** Contracts, including purchase agreements that deal with the transfer of farm real estate, must be in writing. A contract for deed sale of real estate also must be in writing. Leases of farm land that are written for a specified term of years greater than one year also must be in writing.

3. **Contracts to sell goods valued at $500 or more.** The Uniform Commercial Code sets forth the general rule that contracts for the sale of goods valued at $500 or more must be evidenced by writing signed by the party against whom any enforcement might be sought.

4. **Agreements to either lend money or to refrain from collecting money.** Agreements between lenders and borrowers generally must be in writing and indicate the amount of money involved and the repayment schedule. See Chapter 4 for a discussion of various contracts, notes and guaranties involved in financing a farm business.

Exceptions to the written requirement

Strict enforcement of the **Statute of Frauds**—that a written contract must be in place to be enforceable—led to some unfortunate ends. This was particularly true in cases where an oral agreement was in place, but one of the parties used the statute of frauds to break the agreement with impunity, thus causing loss to the other party.

Thus, present law contains two exceptions to the Statute of Frauds, namely, the partial performance rule and estoppel provisions.

1. **The partial performance rule.** This provision states that if one party has continued to perform as though the oral agreement were in force, then the contract will be deemed enforceable.

2. **Estoppel.** An existing trading custom, which is known to both parties, has the effect of creating an enforceable contract despite the wording of the Statute of Frauds.

When performance may be excused; implied contracts

Courts recognize that under certain circumstances it may be impossible, impractical, or illogical to require full and complete performance of all contractual terms. On the other hand, they also recognize the importance of protecting a person's contractual rights. In order to avoid the unreasonable result of requiring perfect and full performance of all

contracts, the courts have developed several rules that excuse persons from full and exact contractual performance under certain circumstances. Three of these rules include:

1. **Substantial performance**

It is generally held that if one party has *substantially performed* a contract, that party is excused from further performance. Substantial performance means, first of all, a performance that is something less than full and exact compliance with the contract's terms. It refers to an incomplete but substantial discharge of contractual duties.

In determining whether substantial performance has occurred, courts look at the extent or value of nonperformance and compare it with the amount of performance that has occurred. If those duties that one has not performed are relatively small, then the substantial performance doctrine comes into play. For example, if a person promised to deliver 1,000 bushels of corn under a contract, but only delivered 999, this would normally be considered substantial performance. The person would be legally excused from delivering the last bushel of corn. However, that person might be compelled to pay for the one bushel of corn that was not delivered.

2. **Impossibility of performance**

Whenever performance depends on the continued existence of a person or thing, destruction of that thing *through no fault* of the contracting parties releases both from their obligations. The same rule has also been applied where an ability to perform the contract depends on the happening of an *event* over which neither party has control.

> To illustrate, suppose Tom contracted to sell a car to John. However, before John has the opportunity to get the car, it is destroyed by a tornado. Under these circumstances, it was neither Tom's nor John's fault the car was destroyed. Thus, both would be relieved of their respective obligations under the contract.
>
> Another example of impossibility of performance might be as follows. Suppose Tom promises to deliver 100 head of feeder pigs at $40 per head to John on April 1. However, before April 1 all of the pigs contract a new disease and die. Again, it can be argued that it was neither Tom's nor John's fault that the pigs died. Therefore, Tom and John are not obligated to perform the contract because of the doctrine of impossibility of performance.
>
> Impossibility of performance may also arise from destruction of the subject matter of a contract, a law that makes the contract illegal or, in the case of a personal service contract, death of a party promising to perform services. Temporary impossibility may also arise where, for example, one of the parties to the contract for personal services becomes ill or disabled. If this occurs, the person would not be required to work during the period of illness or disability.

3. **Frustration of purpose**

If the value of the performance is destroyed by a later event, the contractual obligations are discharged *as long as* the frustrating event was not foreseeable at the time the parties contracted.

> For example, assume Tom promises to pay John $100 if John allows him to use his rooftop as a place to view a parade in which the President will ride. If the President fails to come to the community and the parade is called off, Tom's duty to pay John $100 is excused.
>
> To illustrate further, suppose Tom hires John to combine 40 acres of soybeans, but the beans are destroyed by a flood before they are ready to harvest. Assuming the flood was not foreseeable at the time the contract was initiated, neither party is obligated to perform because the flood has frustrated the purpose of the contract.

Implied contracts

The contracts discussed so far have been *express* contracts, or those to which the parties have explicitly agreed. Courts have also held that some contracts are *"implied in law"*

and some are *"implied in fact."* A thorough discussion of implied contracts is beyond the scope of this writing. However, it should be noted that if one were to sit idly by and watch another party perform beneficial services, knowing that compensation is expected, a contract will be implied. Under these circumstances, accepting the benefits of another's labor, may have implied a promise to pay for such benefits.

Remedies for breach of contract

There are three basic remedies available when one party breaches a contract with another.

1. A lawsuit for damages.
2. A liquidated damages clause.
3. A lawsuit for specific performance.

To *sue for damages*, essentially means asking the guilty party to pay enough money to equal the financial position that would have occurred if the contractual obligations had been met. The claimant has the burden of proving how much money is required to achieve that position.

Because it takes both time and money to bring a lawsuit, many contracts now contain what is called a *liquidated damages clause*. This clause simply states how much money the non-breaching party will receive as damages if the other party breaches the contract. Since this is a part of the contractual agreement, it has the practical function of determining the amount of damages while avoiding the necessity of a lawsuit. Thus, it might be said that the basic purpose of a liquidated damages clause is to avoid litigation. These clauses are generally valid and enforceable so long as, at the time the contract was entered into, they represent a reasonable attempt to determine the extent of damages that would occur if the contract were broken. However, the extent of the damages cannot be so unreasonable as to be a penalty for breaching the terms of the contract.

If an action for damages cannot adequately compensate the non-breaching party for losses under the contract, then a suit for *specific performance* is the remedy. In this kind of lawsuit, the claimant asks the court to require the party to "specifically perform" or carry out the stated contractual duties. For example, damages are considered inadequate compensation when the subject matter of the contract is *unique*. In general, this means that one can sue for specific performance when the subject matter is not readily available elsewhere. Some examples include antiques, a rare art object, and family heirlooms. In addition, *land* is always considered unique. Thus, if there is a written contract to buy a farm, a suit for specific performance could be initiated to force the seller to carry out the contractual duties and convey the title to the buyer.

Some concluding comments

The above discussion outlines the basic principles and general rules affecting the validity of contracts. There are several basic questions to consider before entering into a contract:

- Are the five *essential elements* present? That is, are there:
  1. Competent parties.
  2. Legal or proper subject matter.
  3. An offer.
  4. An acceptance.
  5. Consideration given/received?
- Is a written agreement needed to ensure the contract's enforceability?
- Does the agreement cover everything that it should?
- Are all the terms clear to the parties involved?
- Should there be a liquidated damages clause inserted in the contract?

In order to avoid potential lawsuits, it is always best to have an attorney draft or review a contract before entering into a final agreement. This step will reduce the chances of lawsuits later. Preventive law is generally much more cost effective than spending money to resolve legal problems once they have occurred.

Contractual agreements come into play in many facets of a business. A directory as to where specific types of contracts are discussed in this series, can be found in the final segment of this chapter.

General principles of property law

There is a large body of law related to the ownership and use of farm property. Some of these rules operate as limitations; some operate to enlarge and protect the rights of use by the owner; and still others reflect the responsibility of the property owner to others and to society. But first, some distinguishing characteristics between real and personal property.

Real and personal property: Some differences

Generally, **real property** is immovable property consisting of such things as land and things attached to the land. **Personal property**, on the other hand, is generally movable, but technically includes every other kind of property that is not classed as real property. In addition to **tangible** personal property, such as cows and tractors, there are other kinds of property that are classed as **intangible**. This includes stocks, bonds and, warehouse receipts.

The rules for distinguishing between real and personal property are easily stated, but application is sometimes difficult. For example, problems may arise where items once considered personal property become attached to the real property and are then regarded as real property. **For that reason, both sale and lease agreements should specify which items of personal property are to remain with the real property.**

Public/private restrictions on ownership of agricultural property

Several provisions in the law may or do restrict ownership or control of property. These include eminent domain, easements, covenants, and adverse possession.

Eminent domain

Eminent domain is the right of the public to take private property for public use through condemnation proceedings. Regardless of the public entity embarking on condemnation proceedings, two limits have been established. First, property can be taken only for a **public use**; and second, just compensation must be paid to the affected property holder(s).

Easements

Owners of land have, by virtue of ownership, certain rights in the land of adjoining owners. One of the most important of these rights is an easement. An **easement** has been defined as the right of one property owner to use the land of another for some use. The most common example is a right of way across the land of another property owner. Other types of easements may involve drainage projects and the right to flood another's property.

Easements can be created by:

- Express grant.
- Reservation.
- Prescription.
- Implication.

Generally, easements pass to subsequent owners of land and can be lost only by nonuse or by specific conveyance that terminates the easement.

Covenants

Parties conveying land often make certain agreements concerning its use. These conditions may be written into the deed and become binding upon subsequent owners. Such binding agreements are called *covenants running with the land*. There are two broad types of covenants. An **express covenant** is one that is explicitly stated in the deed. An **implied covenant** is not stated in writing, but is implied from the language of the deed and existing conditions. For example, if a tenant has a long-term lease, and the buyer is aware of it, the situation involves an implied covenant that the tenant can continue use of the property until the lease expires.

Adverse possession

Private citizens can take legal title to property from other persons through **adverse possession**. Generally, this involves situations where one person has held and used the land of another for a long period of time (15 or more years in many states). If the situation meets certain legal criteria, the person holding or using the property would acquire title to the property.

Typically, this proceeding is referred to as a quit title. Some of the elements the court recognizes as supporting a claim of adverse possession include actual, visible, open, continuous and exclusive uses.

Property rights and restrictions: Zoning, land use controls, and other aspects

Most planning and zoning has occurred at the municipal level. The legal justification for controlling the type and intensity of land use has been relatively clear at this level. There has also been general acceptance of regulations in urban-fringe areas. Though rural citizens and landowners have not readily accepted the regulation of property use in predominantly rural areas, the use of various zoning techniques is increasing.

Zoning in these areas has been authorized in all fifty states. Before buying land or buildings and various structures on existing land, check local zoning ordinances and other land use control policies and mechanisms that may be in place. Generally, zoning is based on the concept of public safety versus private use. If a zoning plan is not based on public safety, then such a change in property use may represent a taking, and the property owner should be compensated.

Several other property-related issues are discussed in Chapter 2, Part III of this series. They include: (1) rights and restrictions in water use and drainage; and (2) protecting the environment and the productivity of farmland.

Owner's responsibility/liability with respect to others and their property

The owners or occupiers of a farm owe one kind of duty toward persons or property **adjacent to their land**, and a different set of duties toward persons or property **actually on their land**.

Owner's liability relative to persons/property on adjacent land

Farmers must exercise reasonable care in using their land to prevent injury or property damage to their neighbors. For example, if a farmer collects surface water on his/her land, and later allows it to escape, damaging the neighbor's crop, he/she may be held liable. Crop damage can also occur when a crop duster/sprayer overshoots a given farm, causing damage to a neighbor's crop while under contract to the farm being dusted or sprayed. Similarly, farmers must not interfere with travel on highways adjacent to their land.

Failure to meet fence law requirements can also affect a neighboring farm or farmer. Therefore, know the state laws pertaining to fence requirements and responsibilities relative to any farm animals on the property. These aspects are discussed later in this segment.

Owners' liability relative to persons on their land

The duties of owners towards persons on their land can get very complicated. Legally, such persons are divided into three groups: invitees, licensees, and trespassers. The courts frequently have difficulty deciding which of these fits specific persons coming onto a farm property. This determination is critical, since the extent of the landowner's liability differs considerably among these groups.

Liability relative to invited persons

A person who comes onto a farm with the owner's consent and for the owner's benefit or for mutual benefit is an invitee or business visitor. (A social guest, though invited, is not considered an invitee). A landowner's responsibilities here are twofold. First, there is a duty to warn the invitee of known hidden dangers, and the owner is liable for any injuries an invitee suffers as a result of failure to do so. Second, there is a duty to inspect one's property for hidden dangers. On the other hand, if the invitee knew of a hidden danger before becoming injured, the owner would probably not be held liable.

Liability relative to licensees

A **licensee** is a person who comes onto the land solely for personal benefit, pleasure, or convenience. This might include salesmen and hunters who have permission to hunt. They are **tolerated** rather than **invited** by the owner. Licensees have a legal duty to be on the lookout for hidden dangers. If they are careless in this respect, then the owner is not responsible for any resultant injuries. An owner's duty to licensees is to **warn them**

of any known hidden, dangerous conditions. The owner has no obligation to make the land safe for the licensee, nor must the owner inspect the property to locate dangers.

This type of liability can generally be avoided by proving any of the following:

- That the person did not have permission to enter the property and, therefore, was a trespasser.
- That the object could readily be seen and therefore was not a hidden danger.
- That the owner did not know of the object's presence.
- That the licensee was warned of the presence or location of the object.

Liability relative to trespassers

A **trespasser** is a person who is neither invited nor desired on the property. As such, the owner will be liable for personal injuries only if he/she intentionally inflicts them. An owner need not make the land safe for trespassers, nor warn them of dangers. An owner may use **reasonable force** to remove a trespasser from the property. However, **deadly force** cannot be used unless the life or the safety of the owner or owner's family is threatened. A reasonable amount of force is only that which a jury would consider as just enough to stop the act of trespass or the perceived harm that might occur.

Children and the attractive nuisance doctrine/no trespass signs

If children come onto a property with adults, they receive the same status for liability purposes as the adults they accompany. However, there is an exception to the general rule that charges the property owner with a relatively greater duty to prevent injury to children. It is referred to as **the doctrine of attractive nuisance**. This means that, if a landowner keeps an object or condition on the land that is attractive and dangerous to children, he/she will be liable if a child is injured by that condition.

Property owners have often posted "No Trespassing" signs in the belief that this would eliminate liability for all injured parties. However, with children, the attractive nuisance doctrine may apply. Similarly, such signs may not diminish liability for adults. A person may not see the sign or may believe it applies to "outsiders" only.

Liability for farm animals, including dogs

Ownership of farm animals carries with it certain legal liability for the owner, such as possible liability associated with animals getting loose and damaging a neighbor's property, getting onto a highway, or for injuries to others caused by the animals, especially those occurring on the owner's property.

Loose animals and a neighbor's property: Fence laws and possible remedies

Suppose cattle break through a fence and damage a neighbor's corn crop. Liability for damages caused by the livestock depends largely on where the animals entered the neighbor's property. If they crossed one or more **exterior** fences to enter, the owner of the animals is liable. An exterior fence is any fence other than one located on the boundary between two adjacent landowners. For example, if the animals got out onto the highway and then entered the neighbor's property via a highway fence, this would be considered an **exterior fence entry**. However, if the exterior fence was in disrepair or nonexistent, the owner of the animals may be only partially liable.

A fence located between two adjacent landowners is a **division fence**. If animals cross a division fence and damage the adjoining neighbor's property, the liability for damages depends on who was legally obligated to maintain the fence at the point where the animals broke through. Ordinarily, the responsibility for keeping a specific portion of a division fence in good repair is established by an agreement between the two adjoining land owners. In the absence of such an agreement, state law would prevail, which in turn, will likely involve the local fence viewer for an interpretation.

From the neighbor's perspective, the question is what to do with the stray animals and the possible collection of damages? There are two alternatives. The animals can be driven off the property by the affected neighbor; or they can be impounded and held until the animal owner pays for damages. The animals can be driven off the neighbor's property by

that neighbor in any direction unless the animals entered the property as a result of the neighbor's failure to maintain his/her part of the division fence. In this case, the neighbor must drive the animals back through the hole in the fence. In any case, the neighbor must handle the animals in a reasonable fashion, and in no case can the neighbor kill the animals merely because the animals trespassed.

In order to have the legal right to impound the animals, the neighbor must be in possession of the land and not be at fault for the animals entering the property. The animals must be captured in the act of doing damage or in circumstances that show they had recently done damage. The neighbor also must take responsibility for proper care of the animals until they are reclaimed by their owner. The owner of the impounded animals may get them back by offering to pay for damages to the property. If the animals were wrongfully impounded by the neighbor, the animal owner may recapture them if it can be done in a peaceful manner. If not, then the owner must use legal processes to recover the animals.

Animals on the highway

Animals on the highway are generally there either because they strayed or were driven there. In the case of strays, the owner's liability varies depending on the circumstances. If the owner was negligent in maintaining the fence, which in turn allowed the animals to get on the highway, he/she can be held liable for damages to motorists who collide with the animals, provided the drivers were not negligent themselves. The issue becomes less clear when the fences are in good shape, but the animals still get out, and the owner is not aware of it. In this situation, the owner, must prove that he/she was not negligent, or that the driver of the car was negligent. This calls for a ruling as to **comparative negligence**.

In the case where the animals are on the highway because the owner is moving them to another location, the owner must avoid creating an unreasonable risk of harm to others, by using the degree of care necessary to keep the animals under control.

Visitors injured by animals on the owner's property

Persons may be injured by farm animals such as bulls or dogs. The owner's degree of negligence or blame hinges on:

- Why the visitor—invitee, licensee or trespasser—was on the property.
- The care taken by the owner to eliminate possible threats by the animals.
- The owner at least warning the visitors of potential dangers.

Check for specific state and/or local laws regarding liability for injury resulting from dogs and other domestic animals.

Protecting the business against liability-related claims

Farmers can reduce the risks associated with these various forms of liability in two ways. Because liability is usually based on fault, the most obvious way to reduce liability is to exercise reasonable care in one's daily operations, in the various areas of the business as described above. But, seldom can one eliminate all possible risk of liability. **Therefore, land owners must carry adequate liability insurance to protect themselves and their businesses from such risks**. (See Chapter 6 for more on this type of insurance.)

In some instances, the **corporate form of business organization** may be set up in such a way so as to reduce the potential loss of the owner's personal assets outside the business. The **limited partnership** also can be used to limit the limited partner's liability to his/her assets invested. Other legal entities that limit liability include limited liability partnerships and limited liability companies. (See Chapter 7 for a discussion of these various arrangements).

Tort law involving negligence and liability is a complex area of law. The preceding discussion was designed to help identify places in the business where such liability may occur. It is important to not only be aware of such liability, but also to take steps to remedy the situation and/or determine how best to protect oneself and the business.

A guide to other legal aspects

There are several other areas of law that the owner/operator must be aware of. These include:

- Financial instruments/agreements.
- Labor laws and regulations.
- Business arrangements and tenancy.
- Estate planning and transfer tools.
- Income tax planning and management.

This segment briefly describes each of these areas of law and refers to the parts/chapters in this series where these topics are discussed in more detail.

Financial instruments and security agreements

Borrowing money is an important activity in managing a modern farm business. The financial instruments used in lending circles are discussed in several chapters of this series. Farm mortgages and contracts for deed are discussed in Chapter 2, Part IV. Financing non-real estate debt is discussed in Chapter 4, Part II. Financial-related instruments used when a firm is in financial difficulty are discussed in Chapter 5, Part I.

Labor laws and regulations

There are a number of laws and regulations pertaining to farm workers that a farm manager must deal with. There are human rights issues involved in hiring, managing and dismissing a person, as discussed in Chapters 4 and 5, Part IV. Putting employer/employee agreements in writing is discussed in Chapter 4, Part IV. Various liability issues, wage rates, unemployment insurance, income and social security taxes, worker safety and workers compensation insurance, youth employment provisions and migrant labor provisions are discussed briefly in Chapter 5, Part IV.

Business arrangements and farm tenancy

Business arrangements and farm tenancy have become important tools in farming. Chapter 7, Part II contains an overview of the various types of business arrangements as well as a discussion of how various arrangements can be used together. The chapter also contains a discussion of the process of forming, operating, and dissolving a farm corporation. Chapter 2, Part V contains a discussion of how various employer/employee and joint venture arrangements might be used. Chapter 3, Part V discusses the process of forming, operating, and dissolving a farm partnership. Chapter 1, Part IV covers the process of developing lease agreements involving farmland and facilities. The lease or rental of machinery is discussed in Chapter 3, Part IV. The leasing of livestock is discussed briefly in Chapter 3, Part III.

Production and marketing-related aspects

There are several areas of law that affect production and marketing systems. This often involves production contracts, which are discussed in Chapter 4, Part III. Marketing tools, such as forward contracting, hedging, options, and sales, warranties, and product liability associated with the marketing of farm products are discussed in Chapter 2, Part III.

Income tax planning and management

Tax planning impacts the decision process at numerous points along the way. Chapter 5, Part II provides a general discussion of income tax planning and management.

Estate planning and asset transfers

Estate planning and asset transfers should generally occur throughout one's farming career and into retirement. Chapter 8, Part II contains a discussion of estate planning aspects for a farm operator in his/her mid-career years. Chapter 3, Part VI discusses financial security and death time planning issues for persons in their late career, retirement years. Chapter 4, Part VI discusses business continuation and the tools used in the asset transfer process, as well as tax-related aspects.

Section II

Managing financial aspects of a business

Developing/implementing/controlling annual financial plans

3

- Developing and implementing annual financial plans–a brief review
- Developing a system to meet financial control needs
- Planning and Managing a Farm Business Center

Since every business situation is different, it is impossible to provide a recipe for developing, implementing and controlling annual financial plans. Thus, this chapter first reviews briefly the development and implementation of annual financial plans. (These topics were discussed in more detail in Chapter 4, Part I). It then discusses in some detail the development of an information system that will help control financial plans/affairs. The chapter closes with a discussion of planning and managing a business center that will aid in managing financial affairs.

Developing and implementing annual financial plans–a brief review

Developing annual financial plans

Regardless of the age or stage of a business, a financial plan for the coming year is necessary. This plan should include a monthly or quarterly cash flow statement as well as a projected income statement and balance sheet.

One of the major purposes of **cash flow planning** is to project operating loan needs. In months (or quarters) when cash inflows are projected to be less than outflows, operating loan borrowings will increase. When cash inflows are greater than outflows, then operating loan interest and principal will be paid off or reduced. Both the farm manager and the lender need to know this up front so a realistic credit line can be established.

By making a projected **income statement**, a manager also can determine what operational adjustments will do to the net farm income, when adjustments are made for inventory changes and depreciation. A projected **balance sheet** provides a picture of how assets and liabilities will be affected by the change and the projected change in net worth for that year. Both the farm manager and the lender need this information to determine what projected changes will do to the earning capacity and financial status of the business.

See Chapter 4, Part I regarding the use of the FINFLO computerized cash flow planning tool, which is part of the FINPACK system. FINFLO provides a projected cash flow statement, income statement, and balance sheet.

If using planning tools provided by a lender or others, secure their help in developing a cash flow plan. Also, develop a projected income statement and balance sheet to provide an overall picture as to what the cash flow plan will do to the overall profitability and financial soundness of the business.

Implementing overall business financial plans

One of the key tasks of the farm manager is to coordinate the implementation of the overall business plan. How large a task this becomes will be determined largely by the amount of change involved in the new business plan, and the ease with which this new plan can be integrated into the on-going business; see Chapter 4, Part I.

A farm manager must: (1) coordinate the implementation of the financial, labor, production, and marketing plans, and (2) keep the lender and other resource suppliers informed as to progress as well as possible changes in the plan that may be needed. Use the transition and annual plans developed in Chapter 4, Part I or annual plans developed for the on-going operation, as a guide in implementing the business plan. Of special importance is the development of an accounting and information system to meet monitoring, analysis and reporting needs.

Developing a system to meet financial control needs

The next task is to develop or update an information system to meet financial control needs. To aid in this process, the three steps involved in developing such a system will be discussed. Then the types of information needed for the internal control of an overall business and for meeting reporting requirements will be noted. The segment closes with a summary table to aid the development process.

Monitoring and adjusting the overall business–three basic steps

There are three important steps involved in developing a system designed to monitor and adjust the overall business. These include:

1. Establishing of standards that represent the expected or desired performance.
2. Developing an information system to measure the actual performance and compare it to these standards.
3. Correcting the deviation between standards and plans–the adjustment process.

Step 1. Establishing standards

The results of actual performance must be compared to some quantitative standards or it becomes a waste of time to keep such records. The standards can be expressed in physical or monetary terms, and should be readily measurable. Establishing standards involves selecting a limited number of characteristics that will indicate if the system or business is operating at an acceptable level. These characteristics must not only be related to the overall performance of the business, but they should also be clearly linked to, and be influenced by, specific production, service, and marketing systems. (For more on measuring and analyzing these latter systems see Chapters 2 and 3, Part III and Chapters 3 and 5, Part IV of this series.

The standards set should be realistic, yet provide a challenge. They should be based on, but not necessarily identical to, the values used in the planning process. It is good to also compare one's business performance to that of other farm managers during the same period of

time, and to one's own previous performance. Such a three-way comparison would provide a more balanced view of the business' performance.

Step 2. Measuring the overall business performance; Developing/updating the information system

Measuring and comparing actual performance with the standards previously set is a crucial second step. Develop or update the information system so that it does measure pertinent factors. Three attributes of measurement are important to observe as a system is developed:

1. **Timeliness.** Information must be available in time to make needed comparisons and permit possible adjustments.
2. **Appropriate units.** The measurement must be made in the appropriate units so comparisons can be made with the standards set.
3. **Reliability**. The information gathered must be accurate and consistent.

Step 3. Taking corrective action

Deviations from standards can be corrected in three ways:

1. Change the original plan.
2. Adjust the way the plan is implemented.
3. Change the standards set.

The appropriate combination of these adjustment methods to use, can be determined by considering the following questions:

- Do the established standards result from objectively considering all of the alternatives?
- Can or should adjustments be made in the implementation process?
- Do the proposed changes address the cause of the problem and not just the symptoms?

Meeting internal business control information needs

The monitoring system needed to meet internal business control needs will vary with the type and size of business involved, but will likely involve some level of monitoring during the year as well as for year-end results and trend analysis purposes.

Financial information needed during a given business year

When implementing a new business plan and /or managing a complex, rapidly changing type of farming, year-end reports are likely to be too infrequent to effectively monitor or control the overall business. Review the situation and determine what type of financial information is needed to monitor the business **during the year** and will provide a basis for making more timely adjustments.

For many businesses, this involves gathering **cash flow** information that can be used to compare the cash flow plan with actual cash flows. Reviewing this information periodically during the year helps determine how a financial plan is progressing. An income statement or balance sheet information also is helpful on a periodic basis during the year.

With most types of farms and situations, it is necessary to keep production, marketing, and service records on a similar basis to pinpoint how well the base plan is progressing and for explaining discrepancies in the cash flow situation. These topics are discussed in Chapters 2 and 3, Part III and Chapters 3 and 5, Part IV of this series.

Financial information needed on a year-end, trend analysis basis

One of the more common uses of farm records is for a year-end business analysis. This analysis provides the basis for an annual business plan for the next year. It may involve only an analysis of the overall financial performance of the business, or it may also involve an analysis of production, marketing, labor, machinery, and facility aspects of the business. Decide how detailed the year-end analysis will need to be. Focus on the financial information needed to analyze the overall business.

The data available in records are unique to one's individual business. Several years of data provide a historical track record of business performance over a period of years and under varying conditions. Farm planning typically requires that the data available from previous years be supplemented with additional data on expected prices, input

requirements, and production levels for those systems of production that have not been used before. Nevertheless, the data available from the past provides a sound starting point for forward planning. Thus, identify the kinds of financial information to collect over time for future use in planning business changes later on.

For a detailed discussion of financial analysis tools, measures and analysis procedures, see Chapter 2, Part I. Again, if using the FINPACK system, review carefully the information needed to make effective use of the FINAN program. See Chapter 2, Part I for a brief discussion of FINAN input needs and/or reference the FINPACK user's manual.

If a full year's FINFLO plan is developed at the beginning of the year, the FINAN output will include a planned versus actual cash flow and income statement. The purposes of the planned versus actual analysis are to:

- Determine if the goals and objectives of the plan were met.
- Further analyze the strengths and weaknesses of both the plan and actual operation of the business.
- Gather further information to develop improved future plans.

But, remember when analyzing these planned versus actual data, a good plan does not guarantee a good outcome. Many things can happen that are not under the manager's control. A manager's job is to sort out the things that are controllable and make decisions in those areas. A manager also must be prepared to handle or make adjustments related to factors that are not controllable and take responsibility for the results.

Meeting reporting information needs

Several types of accounting information must be gathered to meet reporting requirements of the government, lender(s), and other business partners. The following are several such reports that are required and the underlying information that must be gathered; there may be others that one's specific situation calls for.

Meeting government reporting requirements

In managing the modern farm business, there is a need to keep appropriate records to meet government reporting requirements. This would include information for reporting income and social security taxes and employee-related aspects. Information needed for reporting on government farm programs, environmental regulations, and other government-related aspects should be determined on a case-by-case basis.

Every farm business is required to file income and social security tax returns. This requires keeping track of financial transactions including:

- Farm income and expense.
- Nonfarm tax deductions and exemptions.
- Nonfarm income and expense.
- Depreciation.

See Chapter 5 for a discussion of income tax planning and management.

Businesses with employees (both family and non-family) also must make periodic deposits of unemployment and worker's compensation insurance premiums, and keep records necessary for hours worked, and wages paid, as well as OSHA reports when necessary. See Chapter 5, Part IV for a discussion of the records that need to be kept relative to farm employees.

Meeting the informational requirements of lender(s)

An **established borrower** with a given lender may have fewer requirements than new borrowers. Possible documentation required of an established borrower includes:

- **A balance sheet** completed and signed by the borrower. Be prepared to explain all the data in it. Provide supporting schedules for all farm assets. Include a current **machinery list**, and, if at all possible, list a fair market value, not just a depreciation schedule value, for each item. If such a list is not available, use the depreciation schedule.

- **A cash flow statement** completed by the borrower. Be prepared to explain where the numbers

came from and what they mean. It would be a good idea to take supporting documents along to verify production levels and prices.

- **All rental and lease contracts**. Be prepared to explain rent and lease arrangements.

- **Other appropriate records** may include supporting records, such as DHIA records, Income Tax Schedule Fs, financial and production histories, and one's net worth change history.

- **Family living expenses.** It would be beneficial to have a family account in which all purchases are recorded by check. Having such an account makes family living costs very easy to identify and justify, not just in terms of the amount spent, but in terms of what was included in the family living expenditures.

A **new borrower** will likely have to supply more information, especially in regard to past business performance. The lender may require all the items listed above plus Income Tax Schedule Fs for the past three years, as well as copies of any land contracts and leases.

The keys to credit renewal (or any credit dealings, for that matter) are to be **prepared** and to **anticipate** what the lender may require. Be **open** and **honest**, but be firm and ready to **logically** and **factually** defend the numbers. A borrower should know the legal and financial obligations in the following situations:

- Before a spouse co-signs a farm loan for the first time.
- Before a parent co-signs a farm loan for a child.
- When a lender requests more collateral to support a given loan.

Reports to business "partners"

Multiple-owner operations and legal forms of business organization other than the sole proprietorship require more detailed records. This occurs because tax reporting requirements are more intricate, and lenders need more documentation when the chain of responsibility and liability is complicated by the legal form and the increased numbers of persons involved.

But perhaps the most important need for more information stems from the likelihood of problems and potential conflicts among the business parties involved. Similarly, individuals involved in informal family partnerships and joint ventures need to rely upon a detailed record system to ensure fairness in the distribution of profits and contributions, as well as later at the dissolution of the arrangement and at the settlement of an estate.

Summary: Selecting a financial information system

Obviously, there are many bits and pieces of information one might gather for use in controlling the business. But, it is important to develop a system that is realistic for the situation. For example, the system should be complete enough to provide sufficient information about the business, to file necessary reports, and to effectively and sufficiently manage the overall business. The system should also provide accurate information and do so on a timely basis. However, farm managers vary tremendously in terms of the information they use to manage, and the extent to which they are willing to devote the necessary time and effort to implement the system.

Table 3-1 provides a summary of the kinds of financial records needed to meet the reporting, monitoring, and analysis needs of a typical farm business. Use it as a guide in setting up an information system for an overall business. See Chapter 5 for a more detailed discussion of records needed for tax planning and management.

Table 3-1. Financial records needed to meet reporting, monitoring and business analysis needs.

	Records needed for business analysis and reporting				
	Income tax preparation	Profit/ loss	Net worth	Cash flow	Family living/ nonfarm analysis
Financial transactions					
Farm income and expense	X	X		X	
Nonfarm income and expense	X			X	X
Nonfarm tax deductions	X				
Debt payments/borrowings				X	
Capital purchases	X	X	X	X	
Inventories/liabilities					
Depreciable assets	X	X	X		
Other farm assets		X	X		
Nonfarm assets			X		X
Farm liabilities			X		
Nonfarm liabilities			X		X

Planning and Managing a Farm Business Center[1]

Farming today is an extremely complex and highly capitalized business that demands a much higher management level in order to survive and prosper. The modern farm business that handles hundreds of thousands of dollars of cash annually needs more than a kitchen table or a corner of a room somewhere in the house.

A *business management center* should be designed, equipped, and managed to provide the support functions needed for a particular farming operation. It may include such things as a manager's office, a record keeping center, workers' meeting room, a center for business planning, a restroom and shower. The following is a brief discussion of the process of the planning and management of such a business center.

Planning a farm business center–some guidelines

In planning or updating a farm business center, first decide on the purpose of the center, the type of center that will meet the needs, the design of the center, and the office furnishings and equipment required.

When planning a business center, there are four major functions to keep in mind:

1. Filtering, processing, storing, and retrieving information.
2. Assembling and analyzing information.
3. Conducting day-to-day operations.
4. Planning the future of the business.

Type of farm business center

The type of farm office or business center depends on the functions to be performed and the people who will use it. Will the center be more than a place to keep records? Will it be a communications hub? Who will use it and be responsible for the various activities and chores?

There are three types of business centers that might be considered:

1. **A farm business center in the home** may be appropriate, particularly if a family member is the bookkeeper. For this type of office, a room (or rooms) should be set aside

1. Adapted from *Planning and Managing your Farm Business Center by* H.E. Workman, et al., North Central Regional Extension Publication No. 233.

specifically for the farm business center. The full-time office may be part of the design for a new home, or result from converting a part of an existing home for this purpose. Separate the office from the normal traffic in the home, thereby enhancing its use as a business management center.

2. **A farm business center detached from the home** is worth considering if there are two or more hired employees, or if someone outside the family does the record keeping. An advantage of the detached office is that it can serve as a headquarters or management hub. If the office is not continuously staffed, there will need to be interconnected communications systems so someone in the home or business can still take messages and contact workers conveniently.

3. **The split farm business center** splits the functions of a complete farm business center between two locations on the farm. For example, the meeting room (lunchroom), shower facilities, and restrooms may be located in a feed center or machinery shed. While the record keeping and business planning functions would be performed in an office that is part of the home or attached to the home. Another form of a split center is a basement containing the shower and restroom for workers, and a business office in a room in the living area of the house.

Designing a Center

The design should include a site plan, a floor plan, and provision for utilities.

- **Site Plan.** Locate the farm business center so that business visitors have little trouble locating the entrance. Give some attention to keeping the area attractive by providing landscaping and walks as appropriate.

  Every farm should have some planned parking for visitors, both family and business visitors (sales persons, consultants, delivery persons) who need to find the business entrance. When the office is in the home, the business entrance is probably the back door or service entrance. It may take some small signs to direct visitors to correct entries.

  The service entrance should be large enough to allow for removal of coats and boots. If the office is a separate room in the house, it should be easy to reach without going through the kitchen or any other room of the house. Eliminating traffic from other rooms is desirable whether the people going to the office are family workers, hired workers, or business visitors. If the office is an attachment to the house, a completely separate entrance should take business visitors directly into the office.

- **Floor Plan.** A farm business center detached from the home should have several rooms. The ultimate plan would include private offices for the manager and associate manager; a secretary/bookkeeper area; a meeting room for workers to get their daily assignments, take their breaks, and eat lunch; and at least one restroom which might have a connecting locker room with showers for workers who desire to clean up before going home after work.

  In a split farm business center, the manager's office and secretary/bookkeeper area may be in the living area of the home, while the associate manager's office, meeting room, restroom, and showers may be part of another building, such as a corner of a machine shed. The offices, especially the secretary/bookkeeper area, should have a view of traffic entering the farm and the activities of business visitors and workers.

  Plan for expansion. Room for expansion is desirable when planning any business, but especially a farm business. It is seldom possible to give up a lease or sell a building and move down the street, as is often done on main street.

- **Utilities**. If a farm business center is more than an extra room in the house, consider servicing it with utilities independent of the house utilities. This includes provision for heating, air conditioning, water heating, electric service, and sewer.

Office furnishings and equipment

A number of items of furniture and equipment are needed to allow an office to function efficiently. Size of the farm business center will be determined by the number of people who use the office. A one-person office will not require as much equipment and furniture as a multi-person office.

The following items of furniture are essential:

- Desks.
- Table, credenza.
- Second desk for equipment.
- Chairs.
- File cabinets.
- Bulletin board.
- Chalk board.

Equipment needs include:

- Desk calculator.
- Telephone, fax machine.
- Waste baskets.
- Computer.
- Printer, scanner.
- Office supplies.
- Field communication system.
- Marketing information network.

Managing a farm business center; information flows and management tips

It would be great if a properly located and equipped farm business center would function on its own. Unfortunately, some human input is still required to make it work. One of the keys is effective management of the flow of information. Another is to set up an effective filing system. This segment closes with some tips from other farm operators on managing a business center.

Managing the flow of information

Never before has it been possible to receive, transmit, and store information in such large quantities and in such little time as it is today. More information can either complement management skills, or it can be overwhelming. Information management consists of five steps:

- **Filtering** information means deciding which magazines and newsletters are worth reading. It means deciding which production and financial data are useful. It also means throwing away junk mail immediately. Resist the temptation to save everything that might be useful in the future.

- **Processing** information is the next step. Information comes through the mail, from meetings and appointments, from one's own on-farm data sheets, and even via computer connections. As information is received, it should be routed in one of four directions:

  1. To the in box or action file.
  2. To the to file box or tray.
  3. To the to read slot.
  4. To the wastebasket.

  Stacked trays, wire baskets, boxes, or simply clearly labeled spots on a shelf are adequate for temporary storage of each type of material. It is vital that information be processed, filed, or read on a timely or regular basis. Once a week is a minimum.

- **Storing** or **filing** information can be relatively painless if some effort is put into setting up the filing system in advance. Efficient information retrieval is made possible by a well-labeled and well-maintained filing system. **A suggested farm business filing index is provided at the end of the Chapter (Table 3-2).** Main headings and file titles can be varied to fit each individual operation. If a numerical coding system is used, be sure an explanation of the code is readily accessible at the desks and near the file itself. Some farm managers use colored labels or folders to distinguish among information dealing with livestock, crops, machinery, labor, or other categories. A similar filing index can be used to organize computer disks and printouts.

  Allocate one or more file drawers to each of several types of material, e.g. business, production, and personal. Files can be divided with hanging file dividers or the manila-type folders.

  Keep reference material related to the major crop and livestock enterprises, buildings,

machinery, and equipment in still another section or drawer, separate from the important business papers. Label folders for record information as well as articles and bulletins to be saved for reference. Place frequently used items in labeled three-ring binders, and store them on a shelf for easy access. Special folders or notebooks for storing computer disks and printouts may be helpful.

If the office is used for personal as well as business records, reserve space for personal records such as family finances, school activities, and volunteer organizations.

- **Retrieval.** As a rule of thumb, if a file folder accumulates more than an inch of material, it should be subdivided or cleaned out.

- **Knowing when to throw or keep.** This is a key aspect in managing information. Table 3-3 provides guidelines as to the number of years to keep items of information regarding a business. Periodically, sort the files and dispose of items that are no longer needed. Of course, careful screening of information before filing it saves time and space later on.

Tips for managing a farm business center

The following suggestions were offered by farm operators who successfully manage their farm business centers:

- One farmer says the farm should also be a marketing center. "Fifteen to thirty minutes a day, depending on how complex your operation is, should be spent in actual marketing–charting, studying, listening, or what have you. You will make more here than any other half hour you spend."

- He also offers this management tip: "I have a pair of tape recorders - one for the car or pickup (plugs in to the cigarette lighter) and one for the office. While I'm in the truck, I record ideas that pop into my mind. Then I come back and listen to them to see how crazy they were or if they made sense."

- One office manager for a multifamily operation says: " The first major thing was setting up a filing system. To me it is a must. You need to have records on the tractors in the files. You can see when it was purchased, when the oil was changed, and what major repairs have been done."

- This same office manager also states: "We're in the process of writing up job descriptions. I think it is really a must to have on hand if one of the partners becomes ill or has to be away for an extended period of time." (See discussion of job descriptions in Chapter 4, Part IV).

- Two brothers with a large partnership operation use their farm office as a center of operations. A key to their operation is the radio communications system. About 20 two-way radios are set up on the office, pickup trucks, combines, and tractors. Cell phones are becoming commonplace.

- A husband and wife team with an office in their home offers this tip: "Use the telephone early in the morning to bunch calls. Let people know when to call."

- A successful crop farmer says grain and soybean farmers need to keep better field records. " I think the biggest mistake a lot of farmers make is that they don't have scales, especially when they rent land." He also has equipment for testing for foreign matter and moisture.

- The brothers in a four-family operation have this to say about their office: "We get in here and we'll talk, discuss what our plans are for the day, for the month, or for the year. That's where this office is really valuable."

- These brothers also have designed a field record card and a map to keep tabs on such things as crops planted, variety, planting rate, harvest date, yield, tillage, fertilizer, herbicides, drainage problems, and weed situations. Maps are mimeographed from ASCS photos. Field record cards can be carried in a portable file in the pickup truck.

Table 3-2. Suggested farm business filing index.

Business section	
BU 1	**Bills paid**
BU 1-1	Farm bills paid (by the month)
BU 1-2	Landlord's bills and records
BU 2	**Income or receipts**
BU 2-1	Crop sale receipts
BU 2-2	Livestock sale receipts
BU 2-3	Other income receipts
BU 3	**Account books and inventories**
BU 3-1	Farm account book - current
BU 3-2	Inventory and depreciation records
BU 3-3	Farm record analysis and summaries
BU 3-4	Bank statements and cancelled checks
BU 3-4	Financial statements
BU 3-6	Labor and payroll
BU 4	**Credit records**
BU 4-1	Notes, mortgages
BU 4-2	Amortization schedules
BU 4-3	Other credit agreements
BU 5	**Taxes**
BU 5-1	Federal income tax
BU 5-2	State income tax
BU 5-3	Property taxes
BU 5-4	Social security
BU 5-5	Estate/gift tax
BU 6	**Insurance**
Bu 6-1	Auto, building, liability
BU 6-2	Life and health
BU 6-3	Worker's Compensation
BU 7	**Business management**
BU 7-1	Leases, agreements, transfers
BU 7-2	Market trends
BU 7-3	Budgets, forward planning
BU 7-4	Farm reorganization plans
BU 7-5	Government programs
BU 8	**Valuable papers**
BU 8-1	Wills, trusts
BU 8-2	Abstracts
BU 8-3	Deeds
BU 8-4	Government bonds
BU 8-5	Stock certificates
BU 8-6	Miscellaneous correspondence

Production section	
PR 1	**Crops and soils**
PR 1-1	Soil test and field history records
PR 1-2	Fertilizer records
PR 1-3	Farm maps and NRCS material
PR 1-4	Major crops (file for each)
PR 1-5	Hay and pasture
PR 1-6	Conservation
PR 1-7	Other (weed control, insects, and plant disease, with crops to which they apply)
PR 2	**Livestock**
PR 2-1	Major livestock enterprises
PR 2-2	Breeding - registration records
PR 2-3	Feeding
PR 2-4	Health
PR 2-5	Production records
PR 2-6	Supply catalogs
PR 3	**Machinery and equipment** (include machinery/ equipment manuals in folders below)
PR 3-1	Cars and trucks
PR 3-2	Tractors
PR 3-3	Wagons and trailers
PR 3-4	Tillage and small tools
PR 3-5	Fertilizing and manure disposal
PR 3-6	Cultivating and spraying
PR 3-7	Planting and seeding
PR 3-8	Harvesting and drying
PR 3-9	Livestock equipment
PR 3-10	Feed grinding and handling
PR 3-11	Water and electrical
PR 3-12	Irrigation
PR 3-13	Supply catalogs
PR 4	**Farm buildings**
PR 4-1	Livestock buildings
PR 4-2	Machinery and crop storage
PR 4-3	Energy conservation
PR 4-4	Catalogs, plans
PR 5	**Computers**
PR 5-1	Hardware manuals
PR 5-2	Software documentation
PR 5-3	Reference material, catalogs

Table 3-3. Guidelines as to how long records should be kept.

	Years to be retained after closing date
Cash records	
Bank statements	Permanent
Duplicate deposit slips	Permanent
Bank reconciliations	Permanent
Canceled checks	Permanent
Drafts paid	Permanent
Sales records	
Cash receipts journal or sales journal	5 years
Sales invoices	5 years
Sales correspondence	3 years
Sales tax records	5 years
Disbursement records	
Cash disbursements journal or purchase journal	5 years
Expense account analysis	3 years
Employee travel expense reports	3 years
Payroll records	
Payroll tax returns	5 years
Individual employee earnings records	6 years
Time cards and time sheets	3 years
Payroll journals	5 years
General ledger	Permanent
Financial statements	
Year-end audit reports	Permanent
Monthly statements and other internal financial reports	3 years
Corporate records	
Certificate of incorporation	Permanent
Charter and bylaws	Permanent
Stockholders' records	Permanent
Minutes	Permanent
Federal and state income tax returns	Permanent
Inventories	
Year-end listing, cost records, etc.	3 years
Retirement plans	
Participants accounts	Permanent
General ledgers and financial statements	Permanent
Correspondence, etc.	5 years
IRS approval letter	Permanent
Other records	
Deeds	Permanent
Contracts, agreements, and leases	20 years after termination
Cancelled notes and mortgages	6 years after cancellation
Law correspondence	20 years
Fixed asset records	Permanent

Financing non-real estate aspects of a business

4

- Financing a farm operation - some basics
- Using personal property as security for a loan
- Special security interest problems; priorities; default provisions
- The rights of unsecured creditors

Financing non-real estate aspects is a complex but critical area of financial management. It includes the financing of personal property and various input purchases, and is the focal point as the manager tries to manage periodic imbalances between cash inflows and outflows. This chapter first discusses some of the basics of financing a farm operation, then delves into the legal aspects involved in using personal property as security for a loan. The chapter closes with a brief discussion of the legal rights of unsecured creditors. **For a discussion of financing real estate purchases, see Chapter 2, Part IV of this series**.

Financing a farm operation–some basics[1]

Important aspects involved in financing a farm operation include the lender/borrower relationship, the various types of loans available, and the nature of contracts, notes and guarantees used in financing a business.

The lender/borrower relationship

Generally speaking, the relationship between a borrower and a lender is considered to be **a formal business relationship**. That is, if a lender gives financial advice to a borrower or otherwise consults with the borrower, the lender is presumed to be acting to further the best interests of the lending institution. Such advice or consultation does not mean that the lender is legally obligated to take whatever action is in the best interests of the borrower. Therefore, the relationship between a lender and borrower is **not** a *fiduciary* (meaning involving trust or confidence) relationship. This means also that generally a lender cannot be sued if the advice causes the borrower to make a bad investment decision.

But there are exceptions to every rule. If a lender exerts inordinate pressure on a borrower in making management decisions, the lender may end up being sued if the management decisions cause a loss. After their experiences during the farm financial crisis of the mid-80s, lenders have tended to back off from unduly influencing a borrower's decision. Of course, a lender in Minnesota, for example, may still get involved in the mediation process and possibly end up restructuring a loan. This may involve debt forgiveness or a change in repayment terms, even though undue influence was not present. See Chapter 5, Part I of this series.

1. Adapted from *Financing The Farm Operation*, AG-FS-2589, by Phillip L. Kunkel and Brian F. Kidwell, Minnesota Extension Service, University of Minnesota, 1989.

While a state may have legal requirements that approach this issue differently, it is best for the borrower to have self-interest as the highest priority when dealing with any lender. The lender has the profitability and financial soundness of the lending institution as a first priority—as it should be.

The farmer/businessman should deal with a lender as he/she would with any other supplier of services. Thus, the borrower should first look out for the profitability and financial soundness of his/her own business. This may involve presenting the plan to two lenders to determine who will provide the lowest cost loan or more services.

Types of loans available

There are three broad types of loans used in farm lending:

1. The longer term, real estate loan.
2. The intermediate term, personal property loan.
3. The operating loan.

The longer term, real estate loan

This type of loan is used in the financing of real estate purchases, such as land or facilities. Institutional lenders account for about 80% of this type of financing. On December 31, 1996, Farm Credit Systems was providing 31% of long-term financing; commercial banks, 30%; Farm Services Agency 5%; and life insurance companies 12%. Private sellers, generally using land contracts, accounted for the remaining 22%. See Chapter 2, Part IV of this series for a discussion of the use of the mortgage and contract for deed instruments commonly used in real estate financing.

The intermediate term, personal property loan

The second type of loan arrangement that a farm manager commonly deals with is the intermediate term loan. Such loans generally are used for purchasing personal property items such as machinery, equipment and breeding livestock. Loans are usually one to 10 years in length, and are part of the assets used, but not totally used up, in the production process. In most cases, however, such loans are grouped together with a third type of financing, the operating loan. On December 31, 1996, commercial banks were providing about 51% of these two types of funding, Farm Credit Systems provided about 19%, Farm Services Agency provided about 6%, with individuals and dealers providing the remaining 24%.

The operating loan

In its purest form, an operating loan is a loan that is tied to the production cycle of a farm commodity. The loan is made for items consumed in one production cycle, such as feed, seed, fertilizer, and feeder livestock. Typically, such a loan is made at the beginning of the production cycle, with advances made under the loan during the production cycle. The operating loan is typically due and payable in full at the end of the production period.

Several characteristics of farm operating loans are important to the farm manager. One significant characteristic is that lenders who make operating loans have generally found it necessary to take **broad security interests**. At the beginning of the production cycle, the value of the commodity to be produced is very low so, for example, the lender may require a security interest in all crops, as well as any stored crops that the farm manager has on hand. The lender also must consider the inherent risks of the farming operation. Hail, wind, and too much or too little rain can result in significant losses to the farm manager and hence to the lender. For this reason, the lender usually requires a lien on the machinery and equipment used in the farming operation as well as crop and livestock produced as additional collateral.

Because of this broad security interest, most farm managers are forced to look to a single lender to provide all of their operating capital. Generally, lenders who make operating loans do not want to finance merely a portion of a farmer's crops or livestock input needs because problems of priorities and intermingling of collateral in the context of farming operations are difficult to resolve. Over 80% of the intermediate term and operating loan volume is provided by secured lenders.

Besides the secured lenders who finance the acquisition of land and personal property, farm managers deal on a regular basis with

suppliers of feed, seed, fertilizer, fuel and chemicals. Here, the farmer typically maintains an account with such suppliers, as well as with the suppliers of services. Suppliers or dealers also may get involved in financing machinery and other fixed assets.

Contracts, notes, and guarantees

When running a farm business, it is common for farm managers to enter into numerous financially-related agreements. They may lease land or equipment. They may borrow money from a bank or other lender to acquire land, livestock, machinery or equipment. They may purchase land on a contract for deed. They may sign or guarantee another party's financial commitments. Each of these arrangements involves a contract of some kind.

The general principles of contract law, as discussed in Chapter 2 form the basis for the various contracts that a farmer may enter into when borrowing money. Below are the typical terms, conditions, and types of promissory notes, as well as third party agreements involved in lending.

Typical terms and conditions of a promissory note

One type of contract that is used in nearly all transactions in which a farmer borrows money is a **promissory note**, which is the borrower's written promise to repay a loan. A typical **promissory note** also includes all the terms and conditions of a loan. In some cases, such terms may be complex and lengthy. Whenever this is true, a **loan agreement** may be used to further explain the terms and conditions of the loan.

All promissory notes must state the amount of the loan and the interest rate to be charged, which may be either fixed or variable. Such notes should also set forth in clear fashion the repayment schedule agreed upon. They will normally also set forth the lender's rights upon default, such as payment of collection costs and a possible acceleration-of-payments clause. Promissory notes should also state whether the borrower may prepay all or any part of the loan, and whether the loan is secured or unsecured.

The four types of promissory notes

Several types of promissory notes can be used, depending on the situation. They tend to vary according to the type of repayment schedule built into the note. For example, a **simple note** is unique in that repayment of the loan is in one lump sum at the end of the term of the note. No periodic payments of interest or principal are contemplated with a simple note. As a result, such notes generally are used in situations involving relatively short periods of time. At the other extreme is a **demand note,** which provides that a lender may demand repayment at any time. A demand note is, thus, very risky for the borrower and not well suited to most farming situations.

An **installment note** provides for periodic payments of principal and interest that will reduce the loan balance to zero by the end of the time period specified in the note. In some cases, an installment note may call for a so-called balloon payment prior to the final payment date. Such a note combines the features of an installment note and a simple note. The reduction in principal through the use of periodic payments over a period of time generally is referred to as **amortization of the loan.**

An **open ended note** is used when a line of credit is arranged by the parties. Under such an arrangement, the borrower establishes a line of credit with the lender in an amount established in the promissory note. The borrower may obtain draws or advances up to the maximum amount specified in the promissory note and may make additional withdrawals against a line of credit even after a portion of an amount previously borrowed has been repaid. The borrower may not obtain more than the maximum amount specified in the promissory note. The open ended note allows a borrower more flexibility in the use of the borrowed funds. Farmers often use this type of loan in obtaining funds for a given production cycle.

Regulation of promissory notes

Many states have enacted usury laws that limit the rate of interest a lender can charge. Parties to a contract cannot avoid the maximum interest rate by merely agreeing to a higher interest in their contract. For example, the maximum rate of interest that can be charged

by a lender in Minnesota depends on the purpose for which the loan is made, the identity of the parties, and the amount of the loan. The Federal Truth in Lending Act was enacted to provide borrowers with meaningful disclosure of credit terms and to protect consumers against inaccurate and unfair credit billing practices. The act imposes detailed reporting requirements on lenders. **Agricultural transactions, however, are fully excluded from the Act**.

Third party agreements

Occasionally a lender may require someone besides the borrower to sign the promissory note. Such requirements may be imposed in cases where the borrower has little additional property that can be used by the lender as a means of repayment. If someone other than the borrower cosigns the note, he/she can be sued for payment if the borrower defaults. The cosigner remains responsible for repaying the loan as long as the borrower and lender operate under the original agreement.

If, rather than cosigning the note, the third party guarantees payment of the loan, the guarantor agrees to pay the lender if the borrower does not. Occasionally a lender requires a guarantor or cosigner to pledge separately owned property as collateral. Using one's own property as collateral for the debts of another requires careful consideration. It is essential that the cosigner or guarantor be fully aware of all the facts and circumstances surrounding the loan. **Unless there are limitations specified, a personal guarantee allows the lender to collect from the guarantor other than the debtor, if there is default on the loan.**

Using personal property as security for a loan

As indicated earlier, intermediate-term loans are typically used for purchasing machinery and breeding livestock. In most cases, however, such loans are grouped together with operating loans, which are used for purchasing production inputs for use during a given production cycle.

Dealing with a borrower who has a solid reputation and who has demonstrated an ability to repay such loans is the best protection a lender can have. But lenders frequently require a borrower to put up some collateral to secure the loan. Some general concepts regarding security interests and the elements involved in creating a valid security interest will now be discussed.

Security interests - Article 9 of UCC

The law governing the legal rights of lenders and borrowers who use personal property as collateral is contained in Article 9 of the Uniform Commercial Code (UCC). The UCC has been adopted in every state and governs virtually all transactions, involving goods (but not real estate transactions). It has greatly simplified the use of personal property as collateral by providing for a nationwide set of uniform rules.

If a lender follows the rules of the UCC, he/she usually acquires a **security interest** in the collateral. A security interest in personal property can be created in either of two situations:

1. When a farmer needs to borrow money but cannot obtain the funds unless some collateral is put up for the loan. Such funds may be needed to plant crops, acquire livestock, or obtain machinery. In such a case, the borrower may grant a lender a security interest in his/her personal property in order to obtain the necessary money.

2. When a farmer does not have sufficient funds to pay the full price of a desired purchase. In such a case, the seller may provide the necessary financing and retain a claim to the property. Such a security interest is referred to as a **purchase money security interest**.

Creation of the security interest

There are several elements necessary for a security agreement to be valid. There are also several steps that must be taken to make a security interest valid against third parties.

Elements of a valid security agreement

In most cases, in order to give a lender a security interest, the borrower must sign a **security agreement**. A security agreement is valid and enforceable once three requirements are met:

- It must be in writing and signed by the borrower.
- It must be collateral in which the borrower has an ownership interest and it must contain a description of the property.
- The lender has given value—a loan—in exchange for the security interest.

Besides these required terms, the security agreement generally will have additional terms that deal with the **borrower's right to sell the underlying collateral**. Although sales of secured property may result in criminal liability, most farm security agreements also provide some restrictions on the farmer's ability to sell the secured property. Some agreements may completely prohibit any sales without the written consent of the lender. Others may allow such sales, subject to restrictions as to how the **buyer of the secured property** is to pay the farmer/ borrower; that is, will payments go to the farmer or to the lender?

A special rule is applicable if the security agreement **covers crops growing** at the time the security agreement is signed, or for crops to be grown in the future. In such a case, the security agreement also must contain a description of the land upon which the crops are to be grown. Again, it is not necessary for the security agreement to contain a complete legal description. A description is sufficient if it reasonably identifies the land at the exclusion of other land. For example, if the description of the land contains the name of the owner, the approximate number of acres, its fractional description (i.e., NW 1/4), the section number, the township and the county, most courts will approve of it. However, errors or inaccurate statements contained in the description, or the total lack of a description, may prove fatal to the validity of a lien on the crops.

Making the security interest valid against third parties

If a lender wants the security interest in the property to be valid against third parties, such as another lender with a claim against the borrower, the lender must notify such parties of the lender's claim. (When the collateral is in the possession of the lender, no additional steps may be required.) This process of giving public notice of a security interest is called **perfection**.

The usual method for perfecting a security interest is by filing a **financing statement** in the proper place. In the case of farm products (crops, livestock, or supplies used or produced in farming operations and products of crops or livestock in their unmanufactured state that are in the possession of a debtor engaged in farming operations) equipment used in farming operations or accounts arising from the sale of any of these types of collateral, the proper place to file the financing statement is with the **county recorder**. With the corporate structure, one must file with the Secretary of State. **States are in the process of adapting a single point filing system, typically with the Secretary of State**.

The financing statement is a brief and relatively simple document. It must describe the collateral and contain the name and address of both the borrower and the lender. It must include the tax identification number of the borrower and be signed by the borrower. The filed financing statement is valid for five years from the date of filing, unless it is terminated before then. This period can be extended if the secured creditor files a continuation statement. As in the case of the security agreement, the description of the collateral contained in the financing statement need not be exhaustive. If the security agreement covers crops, however, a brief legal description and the name of the owner of record of the real estate must be included in the financing statement. (Legal descriptions in financing statements will no longer be required under proposed changes.)

Security interests and motor vehicles–an exception

A major exception to the perfection rules of the UCC applies to security interests in motor vehicles. To perfect a security interest in a motor vehicle for which a certificate of title has been issued, the lender must file appropriate documentation with the appropriate state agency. It is not sufficient for the lender to file a financing statement that covers a motor vehicle with the county recorder. If the lender has properly filed with the appropriate agency, that department will issue the certificate of title directly to the lender. Generally, the lender will retain the certificate of title and show itself as the secured party in its files. This exception usually applies to any item that is "titled" by the state, such as boats and cars.

Special security interest problems; priorities; default provisions[2]

There are several security interest problems that farmers and lenders must deal with. An understanding of which lender has priority and how default may occur are also key elements.

Special security interest problems for farmers and their lenders

Farmers and lenders who take security interests in farm products, receive special treatment under the UCC. In addition, the very nature of a farming operation raises special problems for agricultural lenders and their borrowers.

Government program payments

Farmers may participate in any number of government-sponsored farm programs. Several of these programs result in direct payments to farmer/borrowers from the government. The rights to these payments may be a source of security for the agricultural lender. Such payments may be covered by a proper security interest in crops or in **general intangibles**, a catchall category of collateral under the UCC. Courts have determined that government program payments, such as payment-in-kind payments and Commodity Credit Corporation storage payments, are included in this classification. Similarly, the right to receive payments under a contract for deed is covered by the general intangibles classification. To have a claim against such items, a lender must include a general intangibles clause in the security agreement. In addition, it may be necessary for the lender to file a second financing statement with the **Secretary of State** to perfect a security interest in intangibles.

The after-acquired property clause

Once a lender obtains a security interest under the UCC, it is a durable lien. By means of an **after-acquired property clause**, a lender may be given a security interest in property that will be obtained or acquired after the signing of the security agreement. Thus, livestock, crops, or other goods acquired by the farmer in the future may be included as collateral for the present loan.

In addition, the UCC allows the parties to agree that future advances of money may be given when needed without making a new agreement. Such provisions are important since a lender who has been granted a security interest in all crops, including crops to be grown at a future date, will possess a security interest in crops that are planted and harvested in later years even though the lender may not have financed the planting and harvesting of crops. It is not necessary for a farmer to sign a new security agreement or for the lender to file a new financing statement for each crop year.

2. Adapted from *Security Interests In Personal Property*, AG-FS-2592, and *Termination of Security Interests In Personal Property*, AG-FS-2596, by Phillip L. Kunkel and Brian F. Kidwell, Minnesota Extension Service, University of Minnesota, 1989.

Besides covering property that may come into existence at a later date, the security interest under the UCC remains intact even though the collateral itself may change through the stages of production. A lien on crops continues as the crop matures in the field, is harvested, and stored. A lien on livestock, including all after-acquired livestock, creates a valid security interest in offspring, whether or not they were conceived at the time the agreement was signed.

Proceeds of a sale and the security agreement

Finally, the security interest of a lender extends to proceeds of the collateral. Thus, if a farmer sells farm products, the lien holder is entitled to the sale proceeds by virtue of a security interest in the farm products themselves. If a farmer sells farm products, the purchaser of such products takes them free of a prior perfected security interest, unless the lender has filed a second notice called an **effective financing statement** with the Secretary of State under the provisions of federal statute. If the lender complies with the federal act, and the farmer sells the crops without permission of the lender, the lender can sue the farmer or the purchaser of farm products to either repossess the goods or get damages for the farmer's unauthorized sales.

Priorities: The first-to-file rule; some exceptions

In many cases, two or more lenders may have security interests in the same collateral. In such a case, the question of who has the first claim to the collateral may arise. When two or more lenders file a financing statement covering the same collateral, the general rule under the UCC is that the **first-to-file-rule prevails**, regardless of who actually loaned money first.

Despite this general rule, the priority of a perfected security interest in after-acquired property can be overcome by a **purchase money security interest** if certain procedures are followed. If the party who sells goods, or finances the purchase of such goods, to the borrower files a financing statement within 20 days from the time the borrower takes possession of the goods, the purchase money security interest will be given priority over a lender with an after-acquired property clause in a security agreement. A typical example of such a purchase money financing is the financing provided by the financing affiliates of machinery dealers.

A second exception to the first-to-file rule is provided in certain statutory liens. If a person furnishes services for materials with respect to goods subject to a security interest and receives a lien against the goods by law, that lien will take priority over a perfected security interest. A common example in the farm setting is the case of a machinery repair business.

Another exception to the first-to-file rule is provided for by a **landlord's lien**. A landlord can take a first lien on crops grown on the landlord's land. The lien is for the amount of the unpaid rent. The lien attaches to crops produced on the leased land during the crop year as well as to crop products and proceeds. To protect a first lien against other lenders, the landlord must perfect the lien by filing a financing statement with the renter's county recorder's office within 30 days after the crops begin growing. The landlord's priority ends if it is not enforced within 18 months after it is filed.

Other types of liens that may create exceptions to the first-to-file rule include **mechanics liens** and **veterinarian liens**. The mechanics lien would take priority to the security agreement only if the work was begun prior to the perfecting of the first security interests. A veterinarian's lien will give a veterinarian a priority lien for necessary services provided to said livestock. **Liens are created by state laws, so the law in each state must be researched**.

Possible causes of default; secured party options

The first issue that arises in any decision by a lender to exercise rights under a security agreement is whether the borrower has, in fact, defaulted on obligations. **The Uniform Commercial Code (UCC) contains no definition of default provisions**, but allows it to be defined by the parties to the transaction in their documents. As a result, virtually every

security agreement contains a broad definition of events that constitute a default.

Such events include:

- The failure to make an installment payment when due.
- The sale of collateral without the creditor's prior written consent.
- The failure to keep the collateral adequately insured.
- The occurrence of any other event that causes the creditor to deem itself insecure.

In addition, both the promissory note and the security agreement generally contain an acceleration clause that allows the creditor to demand payment of the loan in full upon the occurrence of any event of default.

Secured party options when default occurs

Once a default has occurred, there are a number of options available to the secured party. Not all of these options involve the enforcement of the security interest under the UCC. For example, in the case of a farming operation, if the primary collateral consists of **growing crops**, the secured party will likely forego exercising the right to foreclose until the borrower has harvested them. In such a case, the secured lender generally will be in a much better position than in enforcing its rights immediately upon default. As a result, even though a default may exist, the secured lender may actually make additional advances to allow the farmer to continue to operate long enough to harvest the crops. The lender may also allow the **borrower to sell the collateral on his/her own**. Often a better price can be obtained for the collateral if the sale is held directly by the borrower.

A second option, especially in the case of farming operations, is the **workout**. The typical workout arrangement usually involves other lenders besides the secured party. In such cases, the workout arrangement generally includes both an extension of time and a payment by the borrower of less than the full amount owed. The purpose of a workout is to restructure the debt to enhance the chances of continuing the business and to maximize the repayment of creditors, without resorting to the formal structure of a Bankruptcy Court. In some cases, the secured party may conclude that its position will be enhanced by encouraging the continuation of the business as a going concern, compared with what it would receive from the liquidation of the collateral.

One final option available to the lender is an **action against the borrower** on the underlying debt. This option may be followed when the secured party suspects that the collateral is insufficient to satisfy the unpaid balance of the debt. It is attractive to the secured party, however, only if the borrower has unencumbered, nonexempt assets that can be reached to satisfy the underlying obligation.

The repossession process

If the secured party determines that it prefers to repossess and sell the personal property collateral, it must comply with state law.

The UCC repossession provisions are clearly drawn to protect the secured party. Once default, as defined by the creditor in the security agreement, occurs, the creditor can:

- Repossess the collateral by self-help or with the aid of a court order.
- Dispose of the collateral by public or private foreclosure sale.
- Retain the collateral in satisfaction of the debt.
- Add the costs of repossession and foreclosure to the unpaid balance of the debt, and pursue the borrower for any remaining unpaid balance or deficiency after sale of the collateral.

The foreclosure of a security interest in personal property under the UCC involves many steps. The events triggering default, the nature of the collateral and the relationship of the parties all contribute to how it will occur.

Conclusion: Know and follow the law

The rules of the UCC with respect to security interests in personal property are of critical importance for the farm operator and lender alike. Farmers must be aware of the significance of each of the documents they are asked to sign. The lender must take all

steps necessary to obtain a perfected security interest in the collateral that has been pledged as collateral for the loan, and to file continuation statements every five years until the loan is repaid and the security interest is terminated. The borrower must be aware of the circumstances under which default would occur and the resultant consequences.

The rights of unsecured creditors[3]

Today's farmer deals with many other business people on an ongoing basis, purchasing needed supplies and making payments in the normal course of business. Such transactions usually do not involve granting the supplier any special protection such as a security interest. In times of financial distress, it may prove difficult for the farm operator to pay unsecured creditors while dealing with secured lenders. As a result, unsecured creditors may be forced to initiate legal action to collect on their accounts.

Civil actions open to unsecured creditors

An unsecured creditor who resorts to legal action must initiate the lawsuit in the appropriate court to seek payment of the amount owed. Subject to legal limitations, the creditor (plaintiff) can determine in which court the action will be brought. Generally, the action will be brought in the county where the defendant (the party owing the money) resides, or in the county where the action arose. For example, presently in Minnesota, the lawsuit may be brought in conciliation court if the amount owed is $7,000 or less. A formal lawsuit with parties represented by attorneys would be held in a district court.

Collection of judgments

If the court determines that the plaintiff (creditor) is entitled to recover a sum of money from the defendant (the borrower), the court will order the clerk of court to enter a judgment in favor of the plaintiff. Once this judgment has been obtained, the plaintiff can docket it with the clerk of court by filing an affidavit giving the defendant's name, occupation, and address.

Once a judgment lien has been docketed, the judgment creditor has priority over other judgment creditors who obtain later judgments against the debtor. This lien prevents the judgment debtor from selling the property, because any potential purchaser of the property will not buy the property unless the judgment has been satisfied. Besides acquiring a lien on real property, a judgment creditor may obtain a court order authorizing the sheriff to carry out the collection of the judgment against the defendant and in favor of the judgment creditor.

Exemptions to creditor's claims

Regardless of the collection procedure used by the judgment creditor, generally, certain property remains free from the claims of creditors under state law. To claim such property as exempt, it must be disclosed to the judgment creditor, who gives the debtor a pre-levy notice. The homestead may be claimed as exempt by filing with the county recorder a declaration of homestead that includes a legal description of the property claimed as exempt.

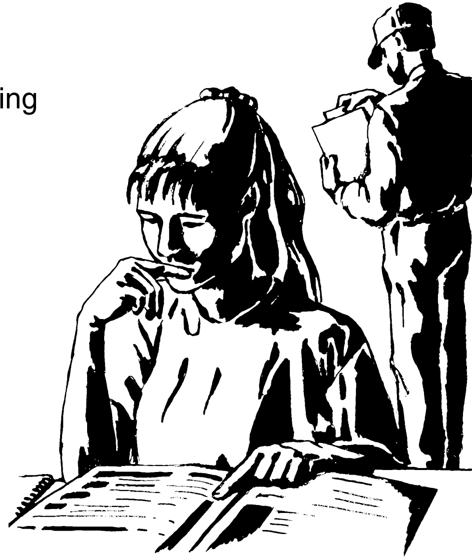
Creditors can garnish only a limited amount of farm earnings. The amount that can be levied is determined by state and federal law.

3. Adapted from *Rights of Unsecured Creditors*, AG-FS-2597, by Phillip L. Kunkel and Brian F. Kidwell, Minnesota Extension Service, University of Minnesota, 1989.

Income tax planning and management[1, 2]

5

- Three keys to sound tax management
- Managing taxes during a given tax year
- Tax management issues and strategies involving capital asset purchases and sales



> ***Special note:***
> *This chapter reflects recent changes in the Federal Income Tax Law. There are on-going discussions of future tax changes. Therefore, refer to more current income tax - related publications as these changes occur.*

Effective income tax planning and tax management are integral parts of good farm business management. The overriding goal is to minimize taxes while maximizing after-tax income. To do this well, one must understand the tax consequences of business decisions. It is not necessary to be a tax expert, but one must know enough about taxes to know how various business decisions might affect tax liability, not only for the current year, but also into the future. Seeking the advice of a tax consultant *before* making a business decision may be the most important tax strategy.

This chapter first discusses three keys to sound tax management. It then turns to the task of managing taxes during a given tax year. The chapter closes with a discussion of tax management issues and strategies involving the purchase and sale of capital assets.

Three keys to sound tax management

There are three major keys to sound tax management. They include:

1. Making tax management an integral part of business decisions.
2. Having a good accounting system in place.
3. Having the maximization of after-tax income as the ultimate goal.

Key #1. Making tax management an integral part of business decisions

A manager of a modern farm business can ill afford to not consider tax consequences when making business decisions. There's too much at stake: too much capital invested and too much money being handled. As a farm business grows and moves into even higher tax brackets, the tax consequences of business decisions will have an even larger impact on cash flows and net income.

The idea is to think through the tax consequences of decisions—everything from the planning and financing of investments to the managing of income and expenses during the year—*before making them*. In the short-run, the timing of transactions plays a key role in tax management. Balancing income between years minimizes year-to-year fluctuations in income and taxes. If at all possible, maintain an annual net income at least equal to the

1. Portions adapted from *Income Tax Management for Farmers*, by George F. Patrick and Phillip E. Harris, North Central Regional Extension Publication #2, Revised 1997.

2. Special thanks to Erlin J. Weness, Extension Educator-Farm Management, Worthington, MN for his suggestions and review of this chapter.

year's allowable nonbusiness and dependency deductions. For example, a family of four may have a taxable income of $17,900 in 1998 and still owe no federal income tax. Similarly, avoid having an unusually high taxable income in any one year.

In the longer run, however, tax management involves much more. The form of business organization under which a farm operates, the manner in which enterprises are organized, and the investment and financing strategies used, can have a major impact on income taxes over time.

In order to make tax management an integral part of business decisions, keep tax considerations in the forefront of the decision-making process. Keep well informed about income tax laws and regulations. A key player here would be a competent tax consultant or, better yet, a financial planner with a strong tax background. Take a holistic approach, with tax consequences being only one factor in the decision-making process.

In addition, secure up-to-date tax references, such as the NCR-2 publication cited at the beginning of the chapter, the *Farmer's Tax Guide* (IRS publication #225), which is updated annually; and other references recommended by tax consultants.

Finally, consider investing in a computer program to help explore alternatives and plan tax strategies. The tax code has become so complex that it is difficult to analyze options without a good computerized tax program. Many tax professionals now have computer programs that can be used to help analyze choices. Or, there are programs available for under $100 that could help in both tax planning and tax preparation. Watch farm publications for reviews of tax software, and check with Extension personnel and other farmers who use income tax software. Tax management is one of the most productive farm management activities. The payoff for computer-based planning is among the best of any farm management task.

Key #2. Have a good accounting system in place

To successfully manage taxes, establish an accounting system that records income, expenses and capital items in accordance with tax laws and regulations. These records should be kept on a timely basis to be able to determine one's tax position at any given time. This information can, in turn, be used in making tax-related decisions when needed.

Tax reporting elections and the accounting system.

The method used in reporting taxable income will have a major impact on one's accounting system. There are two methods of reporting taxable income: the **cash method** and the **accrual method**. The following is a brief review of each method, indicating how various items are handled and the advantages of each.

The cash method of reporting

When filing an income tax return on the **cash basis**, include the following as gross farm income on Schedule F:

- Proceeds from the sale of crops and market livestock raised on the farm.
- Profits (selling price less purchase price) on livestock and other items purchased for resale.
- Other farm income.

Two types of deductions are allowed under this system:

1. Cash farm expenses actually paid during the tax year, regardless of when they were incurred.
2. Noncash depreciation expense allowed on purchased farm improvements, machinery, equipment and breeding and work stock.

The cash-basis filing approach offers several advantages for tax planning:

- It is relatively simple as fewer records are necessary.
- There can be more flexibility for adjusting income and expenses from year-to-year.
- Taxes are postponed if inventories are increasing year-by-year.
- Income subject to social security tax may be less over time than with the accrual method.

Over 95% of farmers use the cash method.

The accrual method of reporting

When filing a tax return on the **accrual basis**, include the following as gross farm income on Schedule F:

- All income from sales made during the year regardless of when payment was received.
- The inventory value of all crops and livestock and supplies on hand and not sold by the end of the tax year.
- All miscellaneous income regardless of source.

To determine net taxable income, subtract:

- The inventory value of livestock and products on hand at the beginning of the year.
- The cost of livestock or products purchased during the year.
- Depreciation, which is calculated in the same manner as under the cash method.

Some of the advantages of the accrual method include:

- If crops are stored to sell the next year, income is leveled to some extent.
- Taxes are kept on a more current basis.
- Social security benefits are often increased because of the way income is reported under this system relative to the cash method.

Some of the disadvantages include:

- Tax planning is virtually eliminated.
- Because taxes are incurred on a more current basis, the time value of money would suggest that the accrual method would likely reduce after-tax income over time.

Changing Reporting Status

When filing the **first tax return for a business**, one chooses whether to file on a **cash basis** or **accrual basis** and **whether to report on a calendar year basis** (January 1 through December 31) or, on a **fiscal year basis** (ending at the end of any month except December). In most situations, a calendar year will be required.

But once a method is chosen, one must continue to use that method for filing income tax returns and keeping tax records. **Changing to another system requires written consent from the Commissioner of the Internal Revenue Service in Washington, DC**. Thus, it is important to enlist the aid of a tax consultant in making the initial decision as well as in deciding upon a reporting change. **The selection of a tax year may also come into play when business organization changes, e.g. from a sole proprietorship to a corporate structure**.

Leaving a "paper trail" and other record keeping aspects

A suitable accounting system should include an appropriate and defensible "paper trail" for income received and expenses paid, therefore:

- Deposit all farm income in a business checking account. Identify sources of all deposits, including those items which are not considered income, such as gifts and money borrowed.

- Use the business checking account to pay all farm-related bills. Remember, checks need to be backed up by a receipt or an invoice. Always get receipts for farm expenses paid by cash as well as by check. Obtain a bank statement each month and check it against farm account records.

- If operating in a business entity such as a partnership or corporation, have separate checking accounts for the business entity as well as individual checking accounts for the parties involved. This is also a good idea in sole proprietorships.

- Set up charge accounts at hardware stores, elevators or other places where considerable business is done. Pay the monthly statements by check. This helps account for small items that would otherwise be bought with cash and not recorded. Remember, if there is income that is subject to tax, every dollar of expenses not deducted will result in unnecessary income taxes.

- Keep records of all medical, dental and hospital bills, including premiums for health insurance, which is now deductible to self-employed individuals, whether deductions are itemized or not (45% is deductible

in 1998 and 1999; increases to 100% after 2003). These items are recorded on tax Schedule A, and may be partially deductible, depending on one's tax situation. Contributions to church, charities, and other nonprofit entities are generally fully deductible, depending on one's tax situation.

Account books suitable for keeping adequate records for tax purposes and farm business analysis are available at most county Extension offices. Computer-based record systems for income tax and farm business analysis are available from some state Extension services, as well as private firms and agricultural cooperatives.

Key #3. Maximizing after-tax income—the ultimate goal

The ultimate goal in tax management should be to maximize after-tax income, not just to minimize taxes. This can be done not only by making the farm business more profitable but also by managing income so it will be taxed at lower tax rates and by deferring taxes.

Reducing Rates at Which Income is Taxed

The two major ways of possibly reducing the tax rate are: (1) careful selection of the form of business organization and (2) reducing fluctuations in taxable income.

The **form of business organization**–sole proprietorship, partnership, or corporation—affects both how one files taxes and how much tax is owed. Tax rates differ for corporations and individuals, so taxes paid as the result of the operation of the farm business may differ considerably over a period of years. Organizational structure also may affect when expenses and losses are deducted and income is reported by the individual owners of the business.

Income tax considerations may or may not be an important factor in selecting a particular type of farm business organization. Operational, legal, and estate planning objectives also should be key considerations. For publications on business organization and farm corporations, contact the local county Extension office. For a further discussion of business organization and related tax matters, see Chapter 7 of this part, and Chapter 3, Part V. With larger businesses, a combination of arrangements may be useful in managing taxes. In Chapter 7 note the illustration of a farm business that is using several forms of business organization and differing tax years for the entities involved.

Reducing fluctuations in taxable income makes good sense from a tax management standpoint. First, progressive tax rates cause a higher tax rate in high income years. In very low income years, one may not be able to take full advantage of the exemptions and deductions available. Strategies for managing year-to-year fluctuations in taxable income are discussed in the next segment of this chapter. Income averaging for farmers was made a permanent addition of the tax code as of October 1998.

Deferring Taxes

Current tax regulations offer opportunities to defer payment of taxes as well as to reduce taxes. Being able to defer taxes is particularly useful for those taxpayers whose income does not fluctuate widely. Deferring taxes from the current year leaves more money for immediate family living expenses, lets net worth build faster, and provides more money for expanding the business.

One way for a cash-method farmer to defer income is to accelerate expenses such as fertilizer, crop chemicals, and feed, while delaying income such as sale of grain and livestock. Accelerated depreciation rates also can be used to defer taxes. For more information on these strategies, see the next segment.

Managing taxes during a given tax year

The discussion in this segment centers around the task of managing income taxes during a given tax year. It focuses on a sole proprietorship situation, reporting by the cash method. (For more complex situations contact a tax consultant). The first portion outlines the process of making periodic income tax projections and is followed by a discussion of some possible tax management strategies.

Special Note: After making rough projections of your tax situation, and considering possible tax strategies, review the situation with a tax consultant, as this is an important, complex area of management.

Making periodic income tax projections

Managing taxes effectively during the year requires periodic tax estimates, particularly when major business decisions are contemplated that may affect income and expenses. These estimates can be made using Worksheet 5-1, found at the end of the chapter, or on an appropriate computer program. The projection procedure presented in Worksheet 5-1 involves a three step process.

Step 1. Project net farm profit (loss)—Schedule F

Estimate net farm profit by projecting: (1) farm sales and other farm income, and (2) cash farm expenses and depreciation.

Estimate farm sales and income

Calculate the amount of farm sales and income for the year to-date. Include:

- Proceeds from the sale of crops and market livestock raised on the farm.
- Proceeds from the sale of poultry and dairy products.
- Profits (selling price less purchase price) on livestock and other items purchased for resale.
- Other farm income such as agricultural program payments, custom work and patronage dividends.

Next, estimate sales and income for these items for the rest of the year. Then add these two sales and income amounts together to arrive at the total estimated sales and income for the year. Insert the totals at line 3.

There are several special items to keep in mind when determining the income to report and how to report it:

- Gains and losses on hedging transactions are ordinary gains or losses and are reported here. Gains and losses from speculative commodity futures or options transactions are capital gains and losses. Such losses are subject to the $3,000 annual net capital loss limitations.

- Don't count any CCC loans as income twice (once in the year the loan was received and once in the year the crop is sold). The loan can be reported as income in the year received, or at the time the grain is either reclaimed, sold, or forfeited. If reporting a CCC loan as income, one must report future loans the same way unless the IRS gives permission to change. Good inventory records will help ensure that the income is correctly reported.

- Do not include indemnity payments for diseased animals as income if the payment will be used to buy like kind or similar property within two years.

- There is an exception to the general rule that crop insurance payments must be reported in the year they are received. That exception applies only to indemnity payments received when crops cannot be planted or are damaged or destroyed by a natural disaster such as drought or flood. The exception allows the reporting of such a payment to be postponed by one year. Certain requirements apply.

Estimate cash farm operating expenses

There are two types of farm expenses that can be deducted, namely, cash operating expenses and depreciation. First, determine the amount of cash operating expenses paid to date. A list of common farm expense items is shown in Worksheet 5.1. Then estimate the likely amount to be spent on these items to the end of the year.

Then calculate the estimated total of these expenses for the year. Total these amounts at line 4.

In addition, there are other expense-related strategies to be considered:

- Pay children cash wages for farm work they actually do, and deduct these as farm business expenses. The wages should be reasonable, and there should be a true employer-employee relationship. To establish this relationship, assign definite jobs, agree on wages ahead of time, and pay the children regularly—just as any other employee. Wages paid to children are included in their income. They may have to file an income tax return. However, with the use of the standard deduction, an unmarried person can earn up to the amount of the deductions without paying any federal income taxes. (In 1998, the standard deduction was $4,250).

  A parent can still claim a child as a dependent if the parent pays more than half of the child's support and the child is either under age 19 or is a full-time student. A taxpayer who qualifies as a dependent of another taxpayer **cannot claim the personal exemption** on his/her own return. Therefore, the taxpayer providing the support—for example, the parent of a minor child—should claim the exemption. Also, wages paid to children by parents are not subject to social security tax until the child reaches 18. The same rule applies to children employed by a partnership if the children's parents are the only partners.

- Consider making the spouse an employee of the business. Certain health insurances and medical costs can then be deducted on Schedule F. See Section 105 of the tax code for details.

- Deduct as many auto and utility expenses as are actually used in the farm business. Half of the total outlay is not enough in many cases. But be sure this use is well documented. Although basic telephone service is not deductible, business toll calls are fully deductible. Extension lines to the barn or machine shop also are deductible, as are extra lines for facsimile machines and computers.

- Deduct the cost of purchased livestock that died or was lost or stolen during the year.

Estimate the amount of annual depreciation

In tax terms, depreciating a capital asset amounts to deducting a portion of its cost each year of the asset's useful life. Capital items last more than a year, so costs are recovered over several years. The amount that can be depreciated is the basis of the asset, a term discussed later in this segment.

In making a tax estimate during the year, include the annual depreciation to be taken this year on existing depreciable items. For planning purposes, use the most common method of depreciation used on existing capital items, for capital purchases made or planned this year. Using faster or slower write-offs is discussed later in this segment.

Determine estimated net farm profit (loss) (line 9)

Next, total lines 4 through 7, the total cash operating and depreciation expenses. To arrive at net farm profit, subtract line 8 from line 3 (total farm sales and income amount). Insert the amount at line 9.

Step 2. Calculate estimated taxable income

To determine estimated taxable income, estimate several other possible sources of ordinary income and then subtract a series of adjustment items.

Estimate adjusted gross income (line 21)

In addition to the net farm profit (line 10) that was determined at line 9 in Step 1, add in the amounts of the various other income items noted at lines 11 through 15. Then subtract any allowable net operating losses that have been previously carried forward (line 16) to arrive at the total estimated gross income for the year (line 17). To arrive at an adjusted gross income, estimate several deductible items and subtract them from total gross income. These items include:

- Any anticipated contributions to IRA's or Keogh plans (line 18).
- As a self-employed person, subtract one-half of the estimated self-employment tax (line 19.

- A self-employed person may deduct a portion of the cost of health insurance (line 21) (45% in 1998 and 1999, increasing to 100% after 2003).

These latter two adjustments are designed to treat the self-employed person in a comparable fashion to a wage earner or corporate owner/employee.

Estimate taxable income (line 24)

Next, calculate personal exemptions for the year (line 22). For example, in 1998, the personal exemption was $2,700. If one is married and has two qualified children, total exemptions would be $10,800. Also, estimate nonbusiness deductions (line 23) as determined on Schedule A of the tax return. This should include allowable medical expenses; taxes and personal residence interest paid, charitable contributions, and allowable miscellaneous deductions. Consider bunching itemized deductions into a given year, and the next year use the standard deduction. Subtract these two amounts (line 22 and 23) to arrive at estimated taxable income (line 24).

Step 3. Calculate total federal income tax due

Estimate federal income tax that would be due. This involves several more calculations.

- First, calculate the tax on the taxable income at line 24, of Step 2. To do this, multiply line 24, by the appropriate tax rate. (Contact a tax consultant for the tax rates for the year being projected).

- Next, determine capital gains income as calculated on Schedule D. Capital gains items include timber, raised breeding stock, land, and stocks and bonds. Be sure to keep separate records of these items as the tax rates on capital gains income are generally lower than for ordinary income. Also, there is no self-employment tax due on capital gains income.

To determine the taxable gain on a capital sale item, one must first determine his/her **basis** in the item. The original cost or unadjusted basis in a purchased asset is the total investment in the asset for tax purposes and is independent of the financing method used to obtain the asset. For example, if one has $20,000 and borrows $40,000 to buy an asset for $60,000, the unadjusted basis is $60,000. If one provides services worth $10,000 in exchange for an asset, the unadjusted basis is $10,000. However, if **a used asset** is traded in on a similar asset, only the adjusted basis of the "trade-in" asset is added to the boot (new money) paid for the unadjusted basis of the "new" asset.

The procedure for calculating the **adjusted basis** of a purchased asset is illustrated below:

	Cash paid	$______
+	Borrowed funds	$______
+	Value of services	$______
+	Adjusted basis of "trade-in" . . .	$______
=	Original cost or unadjusted basis	$______
-	Depreciation claimed	$______
+	Improvements that increase capacity or substantially extend life	$______
=	Adjusted basis	$______

The resultant capital gain is the difference between the selling price of the asset and the adjusted tax basis in the asset. Enter the gain on capital sales to date at line 26, Step 3. **Calculating the gain on depreciable items can be complex, so check with a tax consultant.** Some potential problems are noted later in this segment.

If additional capital sales are contemplated during a given year, first determine estimated taxable income on all other tax-related activities. If it appears that the taxes will be quite high anyway, one may want to delay capital sales, particularly if there is a sizable capital gain involved. Insert this amount at line 26 in the worksheet.

- Then, multiply the capital gains at line 26 by the appropriate capital gains tax rate. As these rates vary by type of property and the length of time they are held, consult the Farmer's Tax Guide for the proper tax rate. Also refer to the discussion of buying and selling capital items later in this chapter. *Enter the amount of capital gains tax at line 27.*

- Determine the estimated total federal income tax due at line 28 by adding together the amounts at lines 25 and 27.

- To arrive at the estimated federal income tax due (line 31), subtract any federal gas tax credits (line 29) received and the federal income tax already withheld, such as on wages (line 30).

Managing taxes: Some possible strategies

Reducing fluctuations in taxable income can help reduce income taxes over time. The following discussion first explores ways of reducing taxable income in an abnormally high tax year. It then focuses on possible tax management strategies where: (1) taxable income is not sufficient to make full use of exemptions and deductions or (2) there is a net operating loss. Social security-related tax management issues also are discussed.

Reducing taxable income during a high income year

When attempting to reduce taxable income, explore ways of either reducing income and/or increasing expenses.

- Income-reducing strategies might include:

  1. Delaying sales of crops and livestock to future years.
  2. Delaying receipt of payment for crop sales, custom work.
  3. Careful management of sales of capital gain-type items by either delaying sales to a future year or disposing of only items involving little or no capital gain.

- There are numerous ways of increasing the amount of expenses. For example, buy extra feed, fertilizer, and chemicals in high-income years to even out income and save taxes. The amount of deductions taken for items purchased in a given year for use in the next year is limited. In some cases the deductible amount is limited to 50% of the total expenses that were reported on Schedule F that were actually used in the tax year under consideration. Some expenses such as farm rent, insurance, and interest payments are not deductible when prepaid. The 50% limit will have little effect on most farmers. However, it is important that prepaid expenses be actual purchases rather than a deposit.

There are several other strategies for increasing expenditures.

- Elect modified accelerated cost recovery depreciation the year an eligible item is bought, in a high-income year to increase deductions and reduce taxable income.

- Elect Section 179 expensing, rather than depreciation, on eligible items purchased during a high-income year.

- Plan expenditures for such things as painting buildings, minor repairs or improvements, and small shop tools, as well as soil and water conservation expenses within limits so they fall in years of high gross income.

- Bunch periodic bills such as repairs, into a year when income is high.

- Bunch personal itemized deductions, such as medical expenses and charitable contributions, into a year when income is high.

- Trade machinery rather than selling it.

- Fund deductible retirement accounts.

- Sell high basis property at a loss.

- Income averaging is now available for farm income on a permanent basis. One can elect to have a portion of farm income, other than gains from the sale of land, treated as if it had been taxable income *spread equally over the three prior tax years*. Although income averaging may help mitigate some high income tax problems, it usually is not as effective as other tax management strategies over time.

Worksheet 5-1. Making a federal income tax projection for a sole proprietor, cash basis.

- Use this worksheet during the year in planning farm business and tax management strategies. **This worksheet is for use with a sole proprietor, cash method reporting.** For more complex business arrangements and accrual accounting situations, seek a tax consultant's assistance.

Step 1. Project expected net farm profit (loss) - Schedule F.

	Amount to Date	Estimated rest of year	Estimated year's total	Line
Farm sales/income :				
Sales of products raised and other farm income				
Cattle, hogs, sheep and wool, etc.	$_____	$_____	$_____	
Poultry, eggs, and dairy products	_____	_____	_____	
All crop sales	_____	_____	_____	
Custom work, prorations and refunds, agricultural program payments, etc.	$_____	$_____	$_____	
Total sales and other farm income	_____	_____	_____	1
Sales of purchased market livestock	_____	_____	_____	
Less purchase cost	_____	_____	_____	
Gross profits on sale of purchased livestock	$_____	$_____	$_____	2
Total Farm Sales/Income (lines 1 & 2)	$_____	$_____	$_____	3
Cash farm expenses:				
Car and truck expense	$_____	$_____	$_____	
Chemicals	_____	_____	_____	
Conservation expenses	_____	_____	_____	
Custom hire (machine work)	_____	_____	_____	
Feed purchased	_____	_____	_____	
Fertilizer and lime	_____	_____	_____	
Freight, trucking	_____	_____	_____	
Gasoline, fuel oil	_____	_____	_____	
Insurance	_____	_____	_____	
Interest paid	_____	_____	_____	
Labor hired (including benefits)	_____	_____	_____	
Rent or lease	_____	_____	_____	
Repairs, maintenance	_____	_____	_____	
Seeds, plants purchased	_____	_____	_____	
Storage, warehousing	_____	_____	_____	
Supplies purchased	_____	_____	_____	
Taxes	_____	_____	_____	
Utilities	_____	_____	_____	
Veterinary, breeding, medical	_____	_____	_____	
Other expenses	$_____	$_____	$_____	
Total cash farm expenses	$_____	$_____	$_____	4
Depreciation on capital assets:				
Machinery and equipment	$_____	$_____	$_____	5
Buildings and improvements	_____	_____	_____	6
Purchased breeding stock	_____	_____	_____	7
Total cash farm expenses and depreciation (total lines 4 through 7)	**$_____**	**$_____**	**$_____**	8
Net farm profit (loss) (Schedule F) (line 3 - line 8)	**$_____**	**$_____**	**$_____**	9

Worksheet 5-1 (continued). Making a federal income tax projection for a sole proprietor, cash basis.

Step 2. Calculate estimated taxable income.

		Amount to date	Estimated rest of year	Estimated year's total	Line
Net farm profit (loss) (line 9, Step 1)	+	$________	$________	$________	10
Net business profit (loss) (Schedule C)	+	________	________	________	11
Other farm income (not on Schedule F)	+	________	________	________	12
Wages	+	________	________	________	13
Rental income (Schedule E)	+	________	________	________	14
Interest + dividends (Schedule B)	+	________	________	________	15
Less net operating loss carry forward	-	$________	$________	$________	16
Total gross income (lines 10 through 15 less line 16)	-	$________	$________	$________	17
Contributions to IRA or Keogh	-			________	18
Less 1/2 self-employment tax	-			________	19
Self-employment health insurance deduction	-			________	20
Adjusted gross income (line 17 - (lines 18, 19 ,20))	=			$________	21
Exemptions (family members x $________)	-			________	22
Deductions (Schedule A or Standard)	-			________	23
Estimated taxable income (line 21 - lines 22 & 23)				$________	24

Step 3. Calculate estimated federal income tax due.

				Line
Tax on taxable income (line 24 x tax rate________%)			$________	25
Capital gains income (Schedule D)	$________	$________	________	26
Estimated tax on capital gains income			________	27
Estimated total federal income tax (lines 25 + 27)			$________	28
Federal gas tax credit			________	29
Federal income tax withheld or previously paid tax			________	30
Estimated total federal income tax due (line 28 minus (line 29 + 30))			$________	31

A note of caution: The tax amount shown at line 31 *is a rough estimate of taxes due.* There are a number of other provisions relating to post high school education which may lower one's tax burden. These include the Hope Credit, the Lifetime Learning Credit, Educational IRA's, and the Deduction of Interest on Student Loans provisions. Also, *the estimated tax due does not include the self-employment tax that will be due.*

Managing taxes in low income or tax loss years

If estimated taxable income is quite low or a negative amount, two broad strategies might be considered.

1. Attempt to increase adjusted gross income to the point that it at least covers non-business exemptions and deductions. This essentially involves reversing the strategies discussed for a high income year (see above discussion).

2. Take advantage of net operating loss provisions.

A net operating loss results when there is an excess of allowable deductions over gross income after certain adjustments are applied to the excess. **If a loss is projected, contact a tax consultant, as computing the loss is complicated.**

One can choose to forego the carry-back and use the deduction to offset income in the 20 years after the loss year. Otherwise, one must carry back the deduction to the earliest year in the carry-back period, then in chronological order to the following years. To make this election, attach a statement to the tax return for the loss year to indicate the choice of foregoing the carry back.

Beginning October of 1998, the carry-back for farmers is limited to five years, and the carry forward period is 20 years. For further information, consult the Internal Revenue Service Publication 536, *Net Operating Losses*.

There are two different ways to file for a refund resulting from a net operating loss. The quickest way is to file Form 1045, *Application for Tentative Refund*. This form must be filed within one year after the close of the year in which the net operating loss occurred. For example, if a net operating loss occurred in 1999, Form 1045 must be filed between January 1 and December 31, 2000.

The other method to claim a refund is to file an amended return on Form 1040X. This form must be filed within three years of the due date (including extensions) for filing the return for the year of the operating loss.

A Special Note: If a business is in financial difficulty, be sure to seek tax and legal help before considering a business liquidation. For tax reasons, it may be advantageous to declare bankruptcy first. For a discussion of these aspects, see Chapter 5, Part I of this series. Better yet, contact an attorney and tax consultant knowledgeable in this area.

Managing self-employment income for social security benefit purposes

Managing income for Social Security benefit purposes can be a major consideration for some taxpayers. In some cases, farmers may wish to increase their net farm income to the maximum amount subject to self-employment tax so they can get larger social security benefits when they retire. The maximum amount of earnings subject to self-employment tax of 15.3% was $72,600 in 1999 and amounts in excess of this amount were subject to the 2.9% Medicare hospital insurance tax. The amount of earnings subject to the social security tax is scheduled to increase in future years.

Increasing earnings to boost social security benefits also increases income tax and self-employment tax. But it may be worth it to gain additional retirement, disability, and/or death benefits. Individuals must weigh the increased cost of obtaining the higher benefits against the value of the benefits in their specific situation. The Social Security Administration will provide information on earnings and an estimate of benefits. To obtain this information, complete Form SSA-7004-PC-OP2, which is available from Social Security Administration offices.

To increase net farm income that will be subject to self-employment tax involves finding ways of increasing annual farm income, increasing off-farm income and/or reducing cash operating expenses and depreciation deductions. Capital gains income is treated as unearned income and thus not subject to self-employment tax.

For years when farm income is low, there is an optional method of determining net earnings from self-employment. This could

help increase one's social security coverage in a low income year or a year with a net operating loss. It can be very important for persons experiencing low earnings to use the self-employment tax opportunities offered under the optional reporting method to qualify for disability benefits, establish survivor benefits, and build credit toward retirement.

Tax management issues and strategies involving capital asset purchases and sales

Effective tax management begins when buying or selling a capital asset such as breeding stock, machinery, land and facilities. So get a tax consultant involved before making the final decision—*not at tax time*. Consider past, present, and projected future financial and tax situations.

Buying and selling breeding stock

With the cash method of accounting, the cost basis of raised livestock is zero, because the cost of raising these animals is deducted during the years those expenses were incurred. In the case of **raised breeding livestock**, the selling price less any expenses of sale is a capital gain. However, to qualify for long-term capital gains, cattle and horses must be held at least 24 months. Other types of livestock, such as hogs and sheep, must be held for 12 months.

In the case of **purchased breeding livestock**, any gain over and above the remaining cost basis, is treated as ordinary income. Any other gain is treated as a long-term capital gain.

Example. Alice sold a breeding cow for $950. She had bought the cow three years ago for $1200. During the three years (plus one-half year for the year of disposition) she took a total of $800 depreciation on the cow. Thus, she had $400 in cost basis remaining at the time of sale ($1,200 original cost minus $800 depreciation). The total gain of the sale was $550 ($950 selling price minus $400 remaining cost basis). *Since the gain is less than the depreciation, it is all treated as ordinary income.*

Capital gain *can* result from the sale of purchased breeding livestock when the selling price (less selling expenses) of the animal is more than the purchase price. In this case, the difference between the selling price (less any selling expenses) and the purchase price would be a capital gain, and any depreciation taken would be recaptured as ordinary income. If there is a loss on the sale of breeding stock (sales price minus selling expenses is less than the adjusted cost basis remaining), that loss is **not** subject to the $3,000 net capital loss limitations for individuals because breeding livestock are Section 1231 assets. The gains and losses on the sale of breeding livestock are reported on Form 4797. On this form, the ordinary income is separated from the capital gain income.

Buying and selling machinery and equipment

Buying: Deciding how to write off the purchase price

Most machinery and equipment purchases made by farmers fall in the 5-year and 7-year MACRS property classes. For a quick write-off, choose the modified accelerated cost recovery (MACRS) method. For a slower write-off, choose the alternative MACRS life for the asset, which offers the straight-line method and usually a longer recovery period.

In a high-income year when one may want the maximum write-off for a machine, there is the option to expense a portion of the cost of qualifying property. (For example: The Section 179 deductible amounts for 1999-2000 are as follows; 1999-$19,000; 2000-$20,000; 2001-$24,000.) After writing off the expensed amount, use MACRS depreciation on any remaining basis left in the asset.

For example, Don wants to buy an $80,000 tractor in 1999. He thinks he will be eligible

to use the half-year convention for the first year's depreciation, since it looks like less than 40% of his new capital purchases will be in the last quarter of the year. He'd like to know the fastest and slowest possible write-offs available under current tax law. As yet, he doesn't know whether it will be a good year or not.

The quickest way to recover costs would be to expense $19,000 under Sec. 179 and depreciate the remaining $61,500 under the MACRS system. Under MACRS, the recovery period for a tractor is seven years. MACRS uses a 150% declining balance method (150% or 1.5 the straight-line amount) for seven-year assets, so annual depreciation would be 1.5/7 times the undepreciated balance of the item. One exception: In the first year, due to the half-year convention, depreciation would be one-half of 1.5/7, or 10.71%. Because of the half-year convention, the depreciation recovery period would extend into the eighth year. Another complication in the MACRS system is that it changes from 150% declining balance method to a straight line method during the period.

The slowest recovery procedures forego the Section 179 expensing method, and use the alternative MACRS method. Once again, one would use the half-year convention for the first year's depreciation. The recovery life under the alternative MACRS method is 10 years, using the straight line method of depreciation.

Selling: Depreciation recapture; related-party transfers

A sale of machinery or equipment may result in the recapture of depreciation if the sale price is above the remaining basis in the machine. Tax-wise, it is usually more prudent to trade in a machine, so that taxes are deferred to a future time.

In the case of a related buyer, the buyer can claim depreciation but not the Section 179 expense method. The related seller may be subject to depreciation recapture. Therefore, gifting or involving the buyer in the new or used machinery purchase may be a better strategy. See Chapter 3, Part V and Chapter 4, Part VI for an in-depth discussion of these issues.

Tax planning in buying a farm

To ensure maximum tax savings when buying a farm, allocate the total cost of the farm on a reasonable basis to:

- Standing crops (if any).
- Depreciable improvements.
- Dwelling.
- Other assets such as timber or mineral resources.
- Land.

In other words, when the deal is struck, identify how much of the purchase price is going for the house, for the land, for the barn. This is because the amounts allocated to these items are handled differently in managing taxes:

- **The cost assigned to the growing crops** is an offset (shown on Schedule F) against the selling price of the crop in the year of sale. The cost basis of the farm is reduced by the amount allocated to the crowing crop.

- **The part of the cost assigned to land** won't be recovered until the farm is sold, because land cannot be depreciated.

- **The part of the cost assigned to timber or mineral resources** cannot be recovered until the asset is sold. When the asset is sold, the selling price is reduced by the depreciation allowance (see Internal Revenue Service Publication 225, *Farmer's Tax Guide*).

- **The cost allocated to the dwelling** can't be depreciated for tax purposes if it is solely a personal residence. One can depreciate a tenant house for tax purposes.

- **Costs allocated to depreciable improvements** can be recovered through depreciation. For tax purposes, the total acquisition cost of depreciable improvements must be broken down and allocated reasonably to each structure or improvement. *The recovery period of each asset is based on IRS rules involving permitted years regardless of the actual age of the improvement.* The costs allocated to the individual depreciable

improvements cannot exceed the portion of the total purchase price allocated to improvements.

- Also, make sure that when the final allocation is made, the amount allocated to the bare land represents a reasonable value for similar land in the community. How the cost is allocated may affect how much one can afford to pay for the farm. This is particularly true when counting on future, after-tax farm income to pay off the purchase price. A closely related issue is the manner of payment of the purchase price. In computing taxable income, the buyer can deduct interest payments but not payments on principal. The seller treats interest as ordinary income; principal payments in excess of cost basis and any depreciation recapture are treated as capital gains.

For more detailed information see: *Tax Planning When Buying or Selling a Farm* by Philip E. Harris, Myron P. Kelsey, Robert S. Smith and Richard Wiegle, North Central Regional Extension Publication #43, 1997. See also Chapter 2, Part IV and Chapter 4, Part VI of this series.

Tax treatment of land development costs

Certain soil and water conservation expenditures may be deducted as a farm expense or can be capitalized and added to the existing basis in the land. To qualify for the deduction, the expenditure must be consistent with a conservation plan approved by the National Resource and Conservation Service (NRCS). If there is no NRCS plan for the area, a state conservation agency plan will satisfy the income tax requirements.

Before making such improvements, check with a tax consultant regarding possible tax treatment and possible recapture of expensed amounts if the property were sold prematurely.

Selling farmland, buildings and residence

Farmland and buildings are treated as capital assets when sold for a gain. Selling these items generally results in a long-term capital gain if the farm was owned for more than one year. However, if accelerated depreciation on the buildings or soil, water, conservation expenses are claimed, part of the gain may be treated as ordinary income.

When selling a farm, one must establish the cost basis of the farm in order to compute the actual gain or loss on the transaction to ensure that one doesn't pay unnecessary taxes. To establish this cost basis, provide a record of the original cost, the cost of improvements made on the property since it was acquired, and depreciation amounts previously claimed.

Improvements made on real estate may be of three types:

1. Improvements subject to depreciation such as farm buildings, silos, fences, tile drains.

2. Improvements such as construction of ditches and similar soil and water conservation expenditures. These are not depreciable, and thus are either claimed as farm operating expenses or capitalized (added to the basis).

3. Improvements to the personal residence on a farm. These are not deductible for tax purposes, except for the part used for the farm business office or to house hired labor. These costs should be added to the original investment in the residence.

The residence should be valued separately when the farm unit is bought. Then, when the farm is eventually sold, it is required that the residence be treated as a separate item. For the sale of a residence after May 6, 1997, a couple filing jointly may exclude capital gains on the residence up to $500,000 ($250,000 for single filers).

Instead of selling the farm, consider **trading or exchanging** it. This is particularly applicable if the present property has a low basis and/or there will be a depreciation recapture on newer facilities. Work closely with a tax consultant when making a nontaxable exchange. This strategy is discussed in more detail in Chapter 4, Part VI of this series.

Using insurance in managing business- and family-related risks

6

- A procedure for making insurance-related decisions
- Using insurance in managing business risks
- Using insurance in managing personal/family-related risks
- Using life insurance in business transition and estate planning–a brief note

Planning an adequate insurance program for a farm business and family situation can be as important as planning which crops to grow and whether to feed or market them. The financial soundness of a business and the financial security of a family may be at stake. Farmers have a variety of insurance needs because of the nature of their business. Rules of thumb with respect to what kinds of insurance to carry and how much to have are suspect since individuals vary with regard to the nature of the businesses they operate and family needs. Individuals also vary in terms of their financial position and their willingness to assume risk.

But this does not mean that one should not invest the necessary time in planning an appropriate insurance program. A sound insurance program must be based on reasoning about what is likely to happen and the cost of protecting the family and business. This chapter first lays out a procedure for making insurance-related decisions. It then discusses the various kinds of insurance that might be used in managing business- and family-related risks. The chapter closes with a brief note on the role of life insurance in making workable business transfers and estate plans.

A procedure for making insurance-related decisions[1]

There are three broad questions to answer when making decisions about insurance needs:

1. What are the chances of any particular financial loss occurring?
2. How great will the financial loss be if it does occur?
3. How can insurance be used for protection from these losses, and how much will it cost?

Chances of a financial loss?

A careful study of all the financial risks associated with a business and family will probably show that some events are very unlikely, and the cost of the insurance cannot be justified. Others are very likely to occur, but insurance may not be available at reasonable rates.

Between these two extremes fall the majority of risks and related insurance needs–they have a good chance of happening, but are not predictable. Good planning recognizes that a loss could occur, however. An insurance agent should have statistics available as to the frequency with which certain events happen.

1. Adapted from *Insurance For The Farmer Business*, by Gary D. Rice and Robert S. Smith, Information Bulletin 167, Cornell University, 1/80, pp. 1-3.

Financial effects of the loss?

After examining the possibilities of a loss, assess the effect or cost of any losses that might occur. For example, some quite likely events may not require insurance protection, as these losses may be so small or regular that they can be treated as the cost of doing business. The loss of a calf in a dairy herd would be such a loss. Other, relatively unlikely losses might present a severe shock to the business or the family's financial situation. Destruction of a dairy barn and herd by fire might be such a happening.

The financial effect of a loss varies with the individual farm and family situation. Insurance protection may be required to protect one farmer from loss whereas the same risk to another farmer may not require protection. The effect of a loss is probably the most important factor in decisions regarding business and family insurance. **A fair rule of thumb is to insure against those events that cannot be absorbed or handled without causing considerable financial hardship.**

Balancing insurance needs with available funds?

After determining the chances of various losses occurring and their impact on a business or family, explore the types of insurance available and their relative costs. Then, compare these costs with the funds available. It is likely that potential insurance costs will exceed the amount of money available, and/or the amount one is willing to spend on insurance. Next, establish priorities as to the types of insurance desired and the amount of protection to be carried.

Several kinds of insurance are so important that it is useless to single out one most important risk insurance category. It is helpful though, to set up a classification system by the relative importance, using a scheme like the following:

Most important

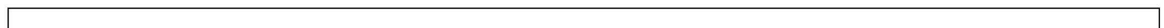
- Fire insurance on all property.
- Major medical and disability insurance.
- Comprehensive public liability insurance.
- Liability and basic no-fault motor vehicle insurance.
- Workers' compensation insurance whether required by law or not.
- Life insurance on the manager.

Important

- Unemployment insurance where required by law.
- Crop insurance.
- Life insurance on the manager's spouse.

Less important

- Comprehensive and collision insurance on vehicles.
- Life insurance for "investment" purposes on children (except to protect their future insurability).



Using insurance in managing business risks[2]

There are five basic types of insurance that play a vital role in protecting a business from various risks:

1. Property insurance.
2. Public liability insurance.
3. Employer's liability or workers' compensation insurance.
4. Motor vehicle insurance.
5. Crop insurance.

Property insurance coverage

Property insurance is used mainly to protect against losses from fires and windstorms. Cost of property insurance varies with location, type of property, presence or absence of fire hazards, type of policy, and type of insurance company selected.

The consequences of a loss from a fire are often severe. Loss of income and high replacement costs add to the burden. The severity of these losses dictate that property insurance be placed high on a manager's insurance priority list. Because the amount and value of farm property can change, it is important to review coverage regularly, including what is "excluded" from coverage, and keep the amount of coverage up-to-date.

Broad liability insurance coverage

There are two broad types of liability insurance coverage: (1) for injuries to the general public while on the premises; and (2) an umbrella coverage for liability wherever it might occur.

Many members of the public come in contact with a modern farm business. Such coverage offers protection for a wide range of situations. The cost of this insurance is relatively low, and even though the chances of loss may be low, the consequences could be very severe—even loss of the business. Therefore, it is important to carry adequate amounts of this type of insurance. Review the policy carefully to determine whether the cost of defending against a claim is included or excluded from the limits of the policy coverage. (See Chapter 2 of this part for a discussion of negligence and liability.)

Employer's liability insurance or workers' compensation

Not all farmers are required to carry either workers' compensation insurance or employer's liability insurance. Check with the local workers' compensation office regarding current requirements. If workers' compensation insurance is required by law, be sure to comply, since costs and penalties for not carrying it can be severe. If it is not required, be sure to have adequate liability and health insurance to cover employees if an injury or liability claim does occur. (See Chapter 5, Part IV of this series for a more detailed discussion).

Motor vehicle insurance

There are several potential risks involved with motor vehicles regardless of who is operating the vehicle. These include personal injury liability, property damage liability, and no-fault insurance. Check the current levels of these insurances to make sure they are adequate. Also decide whether to carry medical, collision and comprehensive insurance.

Crop insurance

Crop insurance provides protection to the farmer against some of the losses that arise from damages to crops. With the Federal Crop Insurance Reform Act of 1994, federal disaster assistance was merged with crop insurance. The act is designed to basically eliminate any future federal disaster assistance programs.

Under the new law, managers are required to obtain at least the catastrophic level of crop insurance coverage (CAT) in order to participate in most USDA programs. Farmers also will be able to purchase additional crop insurance coverage that provides greater protection against crop losses. To protect producers of non-insured crops, the law created a Non-insured Assistance Program (NAP). The NAP protection is similar to the catastrophic coverage noted above, but will protect only in the event of area-wide losses. See Chapter 2, Part III for a more detailed discussion of crop insurance coverages.

2. Rice and Smith, pp. 3-18.

Using insurance in managing personal/family-related risks

It is also very important to have a sound insurance program in place to manage personal and/or family-related risks. There are three happenings that could damage one's "financial house," or destroy it completely. They include:

1. Medical and long-term care costs.
2. Disability that would keep one from working.
3. An untimely death.

Medical and long-term care

There are several levels of insurance protection for health and accident-related events. A sickness or an accident can be a major budget item and can spell financial disaster. Therefore, it is important to have a **basic health insurance plan** in place. Most regular health insurance policies have deductible features as well as upper payment limits. So review them carefully.

Insurance for **hospitalization and surgical expenses and major medical policies** are ways of hedging against more severe sickness and/or accidents. Since it is important to protect against such losses, the manager should consider using policies with sizable deductibles (against costs that can be readily covered) so that insurance costs can be kept in bounds, yet meet protection needs against more catastrophic events.

Long-term care insurance is usually thought of as an insurance that only aging individuals should consider. However, a disabling accident or stroke could occur at any age. Therefore, consider a variety of ways to handle such a situation. See the discussion of long-term care insurance in Chapter 3, Part VI. Also, discuss options with a financial advisor. This is a rapidly changing field.

Income protection/disability insurance

The 1985 Commissioner's Income Disability table indicated that a person 25 years of age has a 50/50 chance of being disabled for 90 consecutive days or more before reaching age 65. The Society of Actuaries reports that at age 37, a person's need for disability income protection is 3 1/2 times greater than their need for life insurance.[3]

Since farming is a very accident-prone industry, it is important to consider income protection insurance. Though it could be used to meet large medical expenses and living expenses, its main purpose should be to assure a reasonable income level if a sickness or recovery of long duration occurs. Certain accidents may result in a permanent disability. Such an occurrence could spell financial disaster for a family. Thus some type of disability insurance should be considered. This would be in addition to any social security or workers' compensation insurance already in place.

When buying disability insurance, determine these facts about the policy:

- Whether the policy is noncancelable.
- How disability is defined; which events are covered.
- Whether there is an average earnings clause.
- Whether occupational disability is covered.

Using life insurance in protecting the farm family

The two most important questions any buyer of life insurance should focus on are: (1) how much insurance, and (2) what kind to buy. In looking over the needs that a farm family has for life insurance, it becomes evident that the **protection** feature is generally more important to a farmer and farm family than the **investment** feature. Thus, the focus here will be on the protection aspect in the use of life insurance.

There are four family protection-need areas to consider:

1. Family income.
2. Debt servicing.
3. Death-time expenses.
4. The farm homemaker or spouse.

3. *Good Neighbor News*, State Farm Insurance Flyer, Spring/Summer 1996.

Family income/economic dependency aspects

As Neil Harl[4] suggests, the unanticipated death of someone on whom others are economically dependent can create serious financial problems. Death of a young husband with several children typifies the problem situation. Ironically, the greatest need for economic protection arises when the young family is least able to afford it. When the children are grown and the estate has increased from other investments—in the farm business or elsewhere—the need for economic protection may be far less.

"Eventually, social security and other survivorship benefits plus the income-creating capacity of accumulated assets may be sufficient for support of those dependent upon the insured's income stream. But in those crucial early years, when support needs are high and income for the survivors would otherwise be low, life insurance may play a crucial role in planning for financial security. With the support needs declining with time, it may be helpful to give some consideration to term insurance—particularly decreasing term insurance."

Harl goes on to state: "Use of life insurance to supplement survivorship benefits suggests a couple of rules of thumb:

- Be sure the insurance protection is concentrated on the income generator(s). Insuring lives of children may be defensible on grounds of: (1) guarding against the problem of non-insurability if illness or disabling accident should strike, or (2) providing for last illness, death and burial expenses. But the overriding need is for adequate coverage of the person(s) responsible for their economic support.
- Review available types of insurance, especially term insurance, with an eye to obtaining adequate coverage at a cost that can be afforded at that stage of life."

Debt/credit insurance

Insurance to cover indebtedness of the business is really the same as providing income to the family. If a farmer dies and leaves enough insurance to cover the debt, the family has the farm assets free and clear to provide income. This also calls for insurance that features protection.

Cash fund to cover death-related expenses

There will always be expenses associated with a death in the family. It may be important that some funds would be available for this purpose. In a farm setting, however, these funds are usually available from sources other than insurance.

Insurance on the farm homemaker/working spouse

A farm homemaker contributes much to the stability and functioning of the farm/family situation in addition to that of parent and homemaker. The death of a farm homemaker can create a heavy economic burden. The death of a spouse employed in town may create an even greater immediate economic burden. Again, some form of term insurance on the spouse should be considered, the amount being determined by the potential economic burden involved.

4. Neil E.Harl, *Farm Estate and Business Planning*, Century Communications, Inc., Niles, Ill., 1991, pp. 204-205.

Using life insurance in business transition and estate planning–a brief note

There are a number of possible uses of life insurance in the areas of business transition planning and estate planning. Since this aspect of life insurance use will be discussed in greater detail in Parts V and VI of this series, the following merely indicates areas where life insurance might be used.

Life insurance in business transition planning

As discussed in Chapter 3, Part V the process of transferring financial control of a large farm business to the junior partner is difficult at best. Life insurance might be used here to:

- Fund key-person insurance.
- Fund buy/sell agreements.
- Provide funds to off-farm heir(s), with the on-farm heir(s) receiving the farm assets.

Life insurance in estate planning

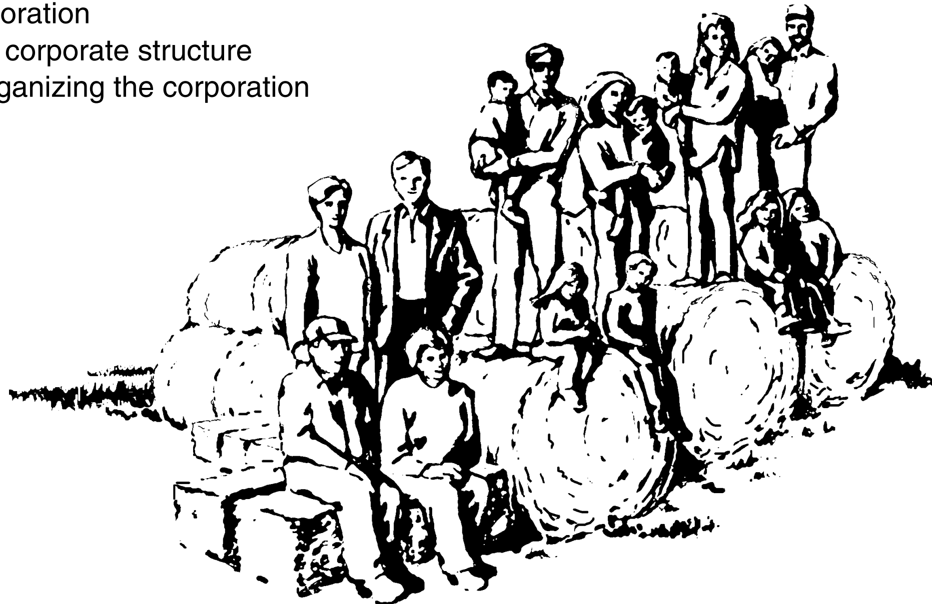
Term-type insurance can be used to pay off debts and meet liquidity and tax demands at time of death. Retirement funds for parents also need careful study. In some instances, an insurance annuity may help to supplement retirement income. These topics are discussed in more detail in Chapter 3, Part VI.

Section III

Business arrangements; retirement and estate planning

7 Developing/updating farm business arrangements

- Selecting and combining business arrangements
- Forming a farm corporation
- Operating under the corporate structure
- Liquidating and reorganizing the corporation



Business arrangements are important areas that need to be reviewed as business plans are developed or updated. This chapter discusses the process of selecting and combining business arrangements and provides some detail concerning the formation, operation, and dissolution of a farm corporation. Those interested in forming a general partnership are referred to Chapter 3, Part V.

Selecting and combining business arrangements[1]

There are several forms of business arrangements that can be used in organizing and managing a farm business. Each form has its place. This segment describes the various business arrangements and where they tend to fit, and then illustrates the use of a combination of arrangements in a large farm operation.

Description of business arrangement alternatives

Table 7-1 shows the three major forms of business organization–the sole proprietorship, the partnership, and the corporation–and describes their basic characteristics. It is important to note their advantages and disadvantages and where they tend to fit in the business organization scheme of things. Note will be made of several other types of business arrangements that might be used as well.

The sole proprietorship

The sole proprietorship is a one-person, owner-operated business. There may be many employees or hired persons, but the proprietor owns, operates and manages the business.

The sole proprietorship is the simplest form of business organization and is easily formed, with few governmental regulations or restrictions. The owner is boss and makes all managerial decisions that affect the business. The owner receives the rewards of good management and effort. Some of its weaknesses include: (1) one person being responsible for a broad range of decisions; and (2) being personally fully liable for all debts and other claims against the business.

1. Portions of this segment have been adapted from *The Farm Corporation* by Dr. Neil E. Harl, North Central Regional Extension Publication No. 11, Iowa State University.

Table 7-1. Characteristics of three major forms of business organization.

Category	Sole proprietor	Partnership	Corporation
Nature of entity	Single individual	Two or more individuals	A legal person separate from shareholders
Source of capital	Personal investment; loans	Partners' contribution; loans	Contributions of shareholders for stock, bonds; loans
Limits on business activity	Proprietor's discretion; legal activity	Partnership agreement; legal activity	Articles of incorporation; state corporation law
Management decision-making/ business control	Proprietor fully responsible	Agreement of partners; may specialize	Shareholders elect directors who manage business through officers selected by directors
Compensation of management	Sole recipient of profits and losses Selected benefits deductible	Partners share all profits or losses; distribution of profits per agreement Selected benefits deductible	Employees profit sharing and fringe benefits program; constant salary for management and employees plus bonus in a profitable year, dividends for shareholders
Record keeping	Must have records adequate to prepare defensible income tax return	Must file information tax return; complete set of records kept so that each partner knows how business stands at any given time	Comprehensive set of accounting records required; minutes of shareholder and board of director meetings
Income taxes	Tax on income of individual and related tax laws	Each partner reports share of profits or loss on individual income tax return	Regular corporation: Corporation files a tax return and pays tax on income; salaries to employees and shareholders deductible. Dividends taxable to individual S corporation: Each shareholder reports shared income, operating loss or capital gain; IRS information report filed by corporation
Liability of owners	Proprietor liable	Partners, except limited partners, are liable for all of partnerships' obligations	Corporation is liable for obligations; in some cases shareholders may be asked to separate payment notes
Continuity under arrangement	Terminates at death of owner; business is liquidated	Is terminated if a partner leaves or dies unless provision is made for its continuation	Forever, or for a fixed number of years; in case of death, shares pass by will or inheritance

The sole proprietorship is the dominant farm business structure in the Midwest. In Minnesota, for example, during 1997 about 88% of farms were organized as sole proprietorships (Table 7-2). However, it is clear that this dominance declines substantially as the size of business (as measured by gross sales) increases. For example, at the $1,000,000 level of gross sales, 37% of farms were incorporated, while only 39% were sole proprietorships.

The general partnership

A general partnership is an aggregation of owners. Two or more persons contribute their assets to the business and share the

Table 7-2. Number and percent of farms by business arrangement type and gross sales, Minnesota, 1997.[2]

Gross sales	Number and percent of farms			
	Total farms	Sole proprietorship	Partnership	Corporation
< $50,000	43,326 59.1%	39,977 92.3%	2,650 6.5%	452 1.0%
$50,000 - 99,999	9,402 12.8%	8,319 88.5%	841 8.9%	215 2.3%
$100,000 - 249,999	12,839 16.9%	10,992 85.6%	1,295 10.1%	524 4.1%
$250,000 - 499,999	5,046 6.9%	3,686 73.1%	809 16.0%	542 10.7%
$500,000 - 999,999	1,933 2.7%	1,131 58.5%	389 20.1%	404 20.9%
> $1,000,000	821 1.1%	323 39.3%	190 23.1%	305 37.1%
Total farms: number Percent of total farms	73,367 100%	64,428 87.8%	6,174 8.4%	2,442 3.3%

2. *1997 Census of Agriculture*, Minnesota, p. 52.

management responsibility as well as the profits and losses with each other. Each partner pledges faith in the other partner and **stands personally liable for the actions of all partners acting within the scope of partnership activities**.

A general partnership is the simplest form of business association involving two or more persons. In structure, it can be likened to an overgrown sole proprietorship. It is easy to create, as no written agreement is required, though one is strongly recommended. With few exceptions, the arrangement can become whatever the partners agree to. Therefore, it can range from a simple to a complex arrangement. Other key characteristics of the partnership are noted in Table 7-1.

As can be seen in Table 7-2, the general partnership tends to fill the gap between the sole proprietorship and the corporation. It is commonly used in mid- to large-sized farming operations, with gross sales between $250,000 and $1,000,000. It can represent a stepping stone to incorporation, remain a continuing means of doing business, or revert to a sole proprietorship if a partner(s) leaves, retires, or dies. It serves a useful role for many mid-sized businesses where income taxes are not a major problem. When combined with a limited partnership or limited liability partnership, it can overcome much of the advantage of the corporation as far as property transfer aspects are concerned.

Some of the *strengths* of the general partnership are the possibility of pooling resources and management skills. It is relatively easy to form, but the arrangement should be well thought out and put in writing. It also provides for a more flexible lifestyle than the sole proprietorship, particularly in livestock operations, and when the opportunity to shift assets and management to the younger partner is a key concern.

Some of the obvious *weaknesses* include:

- Possible differences in goals and objectives among the partners.
- Being personally liable for business debts and other claims against the partnership.
- The fact that the partnership is dissolved if a partner leaves, retires or dies, **unless provision is made for its continuation**.

For a more complete discussion of the formation, operation and dissolution of a general partnership, see Chapter 3, Part V.

The limited partnership and the limited liability partnership

A limited partnership is a special form of partnership permitted under the laws of each state. With this arrangement, the liability of one or more so-called limited partners for partnership debts and other obligations is limited to their personal investment in the business. Thus, the limited partner is only an investor. To retain this limited liability status, the limited partner must not participate in the management of these underlying assets.

A limited partnership must have at least **one general partner** who handles the management of the business and is fully liable for all partnership debts and obligations. The limited partnership can be a very useful tool in business transfers, and also can be used in bringing funds into the business, by limiting the liability of outside investors. Check local state laws for any restrictions placed on outside investors.

Some states have available a third form of partnership, the **limited liability partnership** (**LLP**). Check for its availability for use in the state in which the business operates. Over time, this new arrangement may well replace the general partnership and the limited partnership. For example, this form became available in Minnesota in 1994. It combines the limited liability feature of the corporation and the flow-through tax treatment of the partnership.

As noted earlier, in a general partnership the partnership itself is liable for the wrongful acts or omissions of its partners acting in the ordinary course of business. The *individual partners are, in turn, jointly and severally liable for partnership obligations.* This means that each general partner is ultimately fully liable for any loss or injury caused by any other partner. A **limited liability partnership** would shield general partners from liability for obligations of the partnership. Thus, while the partnership as an entity retains liability for the acts of its partners, the individual partners who were not responsible for the act or omission, will no longer be personally liable. The law *does not* shield a partner from responsibility *for his or her own negligence.*

Because LLPs are new, there is little technical guidance or legal precedent with respect to their operation. Some tax professionals currently believe general partnerships operating in Minnesota, for example, can gain liability protection for their partners at little cost by registering as an LLP. But there are clearly a number of tax and legal issues that have not been fully addressed. For example: how can the partners ensure that the IRS will not seek to tax the partnership as a corporation? Will the limited liability status of LLPs be given effect in other states? What are the tax effects when S corporations or limited partnerships convert to LLP status?

Obtaining LLP status is simple, but check local state laws regarding these aspects carefully, in Minnesota. A general partnership must file a registration form with the Secretary of State containing certain basic information required by the statute. The registration must be renewed annually and the cost to file each year is presently $135. In Minnesota, if the annual LLP registration is **not** renewed annually, the limited liability protection is lost!

The corporation: The regular C-corp and S-corp options

A corporation is a separate legal entity created under the laws of the state in which it is formed. It is a separate business entity distinct from its owners, who are called shareholders because they own shares of interest in the corporation. The major characteristic of the corporate form of business organization is this sharp line of distinction between the business and the owners.

There are two types of corporations: (1) the regular C corporation; and (2) the S corporation. The *C corporation* is a separate tax entity or tax payer. A *tax-option corporation (S corporation)* is a creation of federal tax law. It is a corporation in all respects except that the corporate entity pays no income tax. Instead, each shareholder/owner reports his/her share of corporate income for income tax purposes, much like a partnership.

Factors favoring a regular C corporation include:

- The possible greater ease of *transfer of assets*.
- More certain continuity of business life.
- Possible reduction in personal liability.
- Possible lower income taxes.
- Ability to deduct certain fringe benefits, like lodging and meal expenses.

Some weaknesses of a C-corp include:

- Likely higher costs associated with forming and maintaining the corporate form.
- Possible minority shareholder problems if profits are reinvested in the business.
- Double taxation with regular C corporation if dividends are declared (the Sub-S corporation avoids this problem).
- Likely a more complicated and expensive termination procedure.

The corporation is most widely used with farm businesses grossing $500,000 or more (Table 7-2).

Formation, operation and dissolution of the corporation is discussed in some detail in later segments of this chapter.

The limited liability company; the cooperative

In addition to the more commonly used farm business arrangements described above, less frequently used arrangements are the limited liability company and the cooperative arrangement.

The limited liability company

The limited liability company is basically a hybrid of the corporate and partnership forms of business organization. As the name implies, it offers owners of the business limited liability like a corporation, but is usually taxed like a partnership. This allows the firm to obtain limited liability without facing the "double tax" on business income like the regular C corporation. Nor does it suffer from the restrictions on numbers of owners and other limitations of S corporations.

Laws permitting, the formation of limited liability companies vary from state to state. However, most states now allow this type of legal entity. Like any business entity, it also has its disadvantages and limitations, so discuss it thoroughly with an attorney and tax consultant knowledgeable in this area. The LLCs are now subject to a "check the box" tax alternative whereby at formation of the entity, the entity can select how the entity will be taxed, i.e., as a partnership or corporation.

The cooperative

The cooperative is a legally incorporated business entity, capitalized by its member patrons, that carries out business activities for its members. It remits profits to its patron/owners in proportion to their shares or patronage business.

A cooperative is a very democratic arrangement, with each member/patron having *one vote*. It is taxed on income at corporate rates, but patronage refunds are tax deductible to the cooperative if specified rules are met. To prove nontaxable status, currently 85% of the revenues of the cooperative must be derived from members. Another possible advantage is that interest rates from the Bank for Cooperatives (a farmer-owned lender to cooperatives) are usually lower than for regular farm borrowings.

One notable problem limiting its use in the farm business setting is the one person/one vote rule. For example, a parent could be outvoted by two children, even though the parent provided well over half the assets. As noted in Chapter 4, Part III, in certain types of farming, such as hog production, independent farmers are using the *cooperative structure* to jointly acquire and provide machinery and equipment services, breeding stock, marketing and selling services.

Other operating agreements that might be used

There are a number of other types of operating agreements that can be entered into in conjunction with one or more of the major business arrangements discussed above; see Table 7-3. For example, if *labor is hired*, the manager can enter into a strictly wage arrangement, or a wage incentive, or wage-share arrangement with workers. These arrangements are discussed in Chapter 4, Part IV and in Chapter 2, Part V.

Table 7-3. Selected operating agreements for use in managing the farm business.

Employer/employee	Contracts for services	Leases	Production contracts	Joint ventures
Wages	Independent contractors	Farmland leases	Resource providing	Joint venture
Wage-incentive	Custom hiring of equipment, feeding, etc.	Machinery rental	Product specification	Cooperative
Wage-share	Agency/licensing	Commercial leases	Market access Price or risk sharing	N/A

The manager also can contract for a range of services to be done by someone else, e.g. establish an *independent contractor* relationship to do custom farming, or hire selected operations, and become involved in an agency, licensing arrangement. These arrangements are discussed in Part IV of this series.

Leases are quite common in farming. Leasing farm land and facilities is discussed in Chapter 1, Part IV. Machinery rental and commercial leases also are discussed in Chapter 4, Part IV. **Production contracts** have been used extensively in various types of farm enterprises. It is likely that such contracts will be used even more extensively in the future. A discussion of such contracts can be found in Chapter 4, Part III.

Joint venture arrangements between farmers are becoming quite common. This includes joint ownership of machinery and equipment, joint feeding or breeding livestock arrangements, and the joint marketing of products or the purchases of inputs. These arrangements are discussed in Chapters 2, 3, and 4, Part III; Chapter 3, Part IV; and Chapters 2 and 4, Part V.

The **joint venture** arrangement has most of the characteristics of a partnership. The main difference is that a joint venture usually involves only one part of each participant's financial and business holdings. In this case, the participants would normally be liable for just adverse happenings within the scope of the joint venture.

A RED FLAG! The joint venture arrangement must make clear what part of the business is being joint ventured and it must be operated in such fashion. Otherwise, the joint venture may be looked upon as a partnership operation between the parties, making the parties potentially liable for each other's acts involving all aspects of their respective businesses.

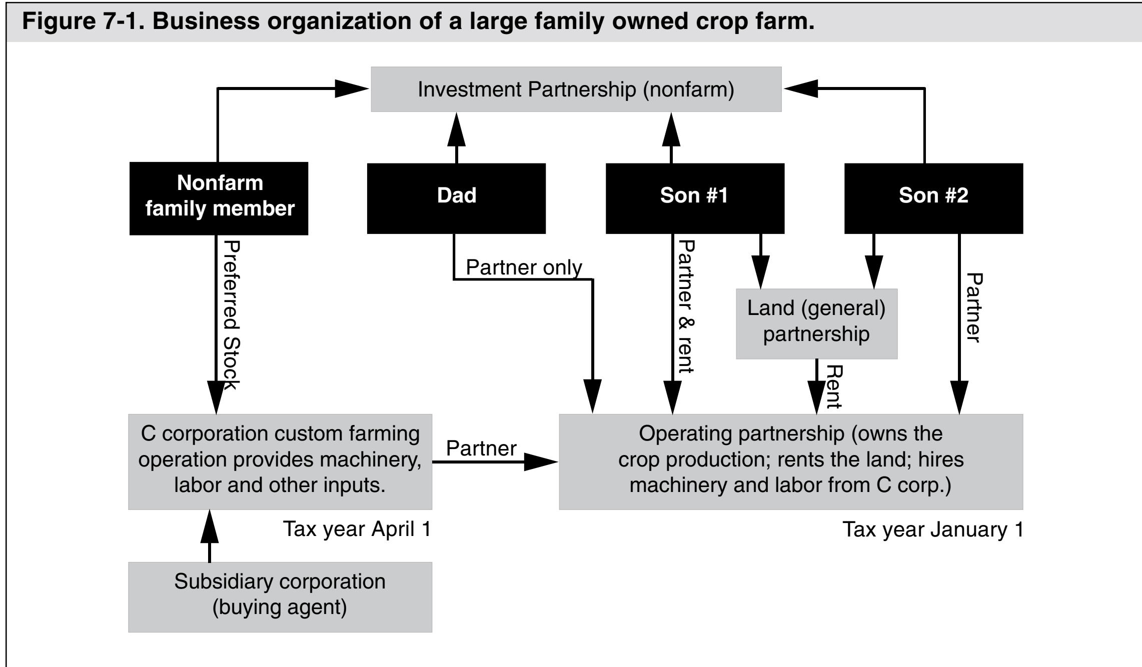
Using a combination of business arrangements–an illustration

With larger, multi-owner farm businesses, a combination of business arrangements is often called for. The following is an example of the business organization of a large crop farm involving a father, two farming sons, and an off-farm heir, Figure 7-1.

This arrangement utilizes the sole proprietorship, general partnership and C corporation, but does so in a very unique manner. Son #1 owns some land in a sole proprietorship and rents it to the operating partnership. Other land owned by the two sons has been placed in a **land partnership**. At present, this partnership is a general partnership, but it is planned that it will become a limited liability partnership when transfers to the next generation become an issue. (See earlier discussion of the limited liability partnership.)

They have an **operating partnership** that owns the crop production and rents the land from the land partnership or individuals. A **C corporation** has been formed to serve as a custom farming operation for the operating partnership. It rents or buys machinery; labor is hired by the corporation; and a **subsidiary corporation** (C) has been established to serve as a buying agent for certain inputs that are then sold to the C corporation or to other area farmers.

Figure 7-1. Business organization of a large family owned crop farm.



Such a combination of arrangements serves several useful purposes for their business. It keeps much of the *risk of liability* confined to the C corporation, which limits individuals' risk of exposure. It provides a structure that makes it relatively *easy to keep track of costs and revenues* that belong to each of the farm's enterprises and assets. Each part or business entity is described economically by an enterprise budget, where costs and returns are regularly recorded and analyzed. This carefully structured business arrangement has yielded two major bonuses:

1. The enterprise accounting of this highly structured business has uncovered the high cost of machinery ownership. The owners now consider owning machinery an expensive luxury to avoid if at all possible. They custom hire combines, and rent or lease other expensive machinery such as large tractors and trucks. An exception is sugar beet harvesting equipment. Because timeliness is so critical and the resale value is limited, they still own and operate this equipment.

2. Their farm business organization has helped them identify land as a relatively good long-term investment.

The operating partnership has a calendar year tax year, while the C corporation has April 1— March 31 tax year. This permits flexibility in the management of income and expenses. The three operating partners (Dad and the two sons) plus the C corporation entity provides four business "individuals" in dealing with government payment limits.

Their arrangement also provides flexibility in estate planning and asset transfers. The land partnership can become a limited liability partnership. And for the one nonfarm family member, they have established an investment partnership made up of nonfarm investments. This provides assets and income for the nonfarm heir without his/her direct involvement in the business entity. However, the nonfarm heir does own *some preferred stock* in the C corporation, which provides that person with some income, but no voting rights.

But such an arrangement is not for everyone. It requires a set of financial accounts and separate checking accounts for each of the entities. Separate tax returns also must be filed. Appropriate meetings must be held and minutes recorded. But, it does illustrate the fact that, if one has identified goals and purposes to accomplish, there are a number of arrangements to be considered and possibly combined to meet management needs.

Forming a farm corporation[3, 4]

The corporation is a complex form of business organization in terms of its organizational and operational formality. This is due in large part to the fact that corporations of all sizes are organized and operated under the same laws of each state. **Thus, the most important step in incorporating is in making the decision whether to incorporate**. The decision should be made only after careful consideration, and with the help of a tax consultant and an attorney well versed regarding one's specific situation and the farm incorporation process.

Here, it is assumed that one has carefully analyzed the situation and has decided to incorporate. The steps in incorporating the business are discussed first. This is followed by a list of the items usually contained in the articles of incorporation, and a brief discussion of the capital structure options to be considered. Getting prepared for and the holding of the first board of directors meeting concludes the segment.

Steps in incorporating a farm business

The incorporation procedure is roughly the same for all states. A composite illustration based on procedures in several states follows:

1. The incorporators should develop a pre-incorporation agreement dealing with the major rights and duties of the parties after the corporation has come into existence.

2. Articles of incorporation are filed with the Secretary of State office of the state in which the business is located. The state issues a certificate evidencing the organization of the corporation.

3. The shareholders or incorporators hold an organizational meeting and elect directors. In some states the initial directors are named in the articles of incorporation.

4. The directors meet to elect officers, adopt bylaws, select a depository bank, issue stock (or stock and debt securities) in exchange for property or cash or both, and begin business in the name of the corporation.

Pre-incorporation agreement/articles of incorporation/capital structure

The following is a brief description of the nature and purpose of a pre-incorporation agreement and the articles of incorporation, and the determination of the corporation's capital structure.

The pre-incorporation agreement

A pre-incorporation agreement among the prospective shareholders is not legally necessary, but is desirable. It serves as a guide for the incorporators while the corporation is still in its formative stage.

A pre-incorporation agreement for a farm corporation usually includes:

- The agreement to incorporate and the kind and number of shares of stock each shareholder agrees to acquire.
- Restrictions on transfer of stock.
- The prospective directors and officers, their duties and perhaps their salaries.
- Other important items such as decisions that will require unanimous approval, voting rules, and quorums.

Many of these items will later be included in the articles of incorporation or bylaws.

Articles of incorporation

The articles of incorporation contain the powers and limitations of the corporation and its shareholders. This is the basic charter or governing instrument of the corporation. Some states provide forms for the articles of incorporation.

Articles of incorporation generally include:

- Names and addresses of the incorporators.
- The name of the corporation.
- The registered office or agent. (See items 15 and 16 of Worksheet 7-1 at end of chapter.)

3. Harl, *The Farm Corporation*.

4. See also *Farm Estate and Business Planning* by Dr. Neil E. Harl, which contains seven chapters on the farm corporation.

- The duration of the corporation.
- The powers and purposes of the corporation.
- Class, number and value of shares of authorized stock, voting rights, and any preferences or restrictions (see discussion below).
- Number of directors.
- Minimum stated capital requirements (state statute).
- Oath and signatures of incorporators.

Completed copies of these articles must be sent to the appropriate state office along with the incorporation fee. If they are in proper order, the state files a copy and returns the others to the incorporators along with a *certificate of incorporation*. Local filing may be required as well; an attorney will know the state requirements.

Determining the capitalization structure

An important component of the articles of incorporation is the capitalization structure, which includes defining the classes of stock to be authorized and the possible use of debt securities.

Kinds and amounts of stock to be authorized

Typically, farm corporations are created with one class of **common stock** authorized. But other classes may be defined in the articles with the classes differentiated on the basis of:

- Voting rights.
- Rights to receive income annually.
- Preferences in receiving assets on liquidation.
- Term of commitment as an investor.

Common stock, the risk-bearing fund of the corporation, usually has voting rights (one vote per share); rights to annual income only when dividends are declared by the directors; no preference on liquidation; and an indefinite term of commitment to ownership of the security. A **class of preferred stock**, by contrast, might have no voting rights; a specified annual dividend rate; priority on liquidation ahead of the common stockholders; and an indefinite commitment to ownership.

Generally, about *twice as much stock* is authorized as is needed for immediate issuance. The rest is held by the corporation for possible later issue as assets are transferred to, or services are performed for, the corporation. Each state may have its own laws restricting and/or taxing the number of shares authorized for issuance by a corporation.

Kinds and amounts of debt securities to be authorized

A corporation may also, generally by board of director action, create one or more classes of debt securities. These might include notes (short term, unsecured debt obligations), debentures (longer term, unsecured debt obligations), or bonds (longer term, secured obligations). The debt securities are typically defined with reference to the four characteristics noted above with regard to stock. Debt securities generally confer no voting right on the holder; the holder is paid income annually at a fixed rate of interest; gives the holder priority on liquidation ahead of shareholders, and involves a fixed term to maturity.

Debt securities can serve several useful purposes in a family farm business, including:

- Reducing the investment required for on-farm heirs to gain voting control over the corporation.
- Assuring investment income to the parents and off-farm heirs.
- Providing a means for removal of some earnings from the corporation as tax deductible interest.

Recent tax rulings, however, suggest that issuance of debt securities may represent a taxable event unless handled properly.

Getting prepared for the first board of directors meeting

Upon acceptance of the articles of incorporation by the appropriate state office, the corporation gains legal status permitting it to own property, hire employees, and otherwise carry on the business of farming. Before the organizational meeting of the board of directors—which is an important occasion—

there are several tasks to be done and issues to be addressed including:

- Inventory/valuing of assets.
- Other asset-related issues.
- Tax-related issues.
- Employee-related issues.

Inventorying/valuing assets

Individuals wishing to transfer property to the corporation should prepare an inventory. The inventory normally lists:

- A description of each item of property to be transferred to the corporation.
- Its fair market value (typically determined by the board of directors).
- The adjusted income tax basis for the property.
- Any indebtedness on the property to be taken over by the corporation.
- The method of depreciation presently being used.

For each individual transferring property to the corporation, the *undepreciated basis value minus indebtedness* constitutes the **basis value** of stock received. Thus a transfer of $180,000 of basis property assuming a $40,000 liability against it, (providing the debt is assumed by the corporation), would result in a basis value of $140,000 in the shares of stock that are issued.

However, the value and number of shares of stock issued is based on the **fair market value** of the assets transferred to the corporation. Based on the above example, if the fair market value of the assets transferred to the corporation is $500,000, the share holder would have an income tax basis in the stock of $140,000. Transfers of assets into a corporation should be discussed thoroughly with your tax consultant and attorney.

Other asset-related issues

Two other asset-related issues need to be addressed: (1) Tax-free or taxable exchange? and (2) Which assets to incorporate?

Tax-free or taxable exchange?

The choice between paying and not paying income tax on the gain wrapped up in property transferred to the corporation (the difference between a taxable and tax-free incorporation) is not really an election. The choice is made in the way the transfer is handled.

For a *tax-free exchange to happen, two conditions must be met*: (1) those transferring property to the corporation must end up with at least 80% of the stock (they can't make massive gifts at the time the corporation is formed); and (2) the property must be exchanged solely for "stock" in the corporation. Such transfers must meet the requirement set forth in the Internal Revenue Code Sec. 351.

Until 1989, property could be issued for stock or securities in the corporation. For transfers after October 2, 1989, for a tax-free exchange, property can be transferred only for stock. Debt securities issued as part of a tax-free exchange are treated as **taxable boot**.

Because the stock received by the transferrers of property may later be sold or given away, it is important to compute its **income tax basis**. For a tax-free exchange, with no gain recognized on incorporation (which is usually desired), the income tax basis for each transferor's stock is figured by subtracting the indebtedness taken over by the corporation from the tax basis of the property going into the corporation.

A key point: If a transferor's liabilities that are taken over by the corporation exceed the income tax basis of assets transferred, *a taxable gain is incurred as to the excess*. This problem has arisen with some regularity in recent years as some farmers have incorporated as part of a general refinancing effort because of heavy debt obligations.

Which assets to incorporate?

For some, the decision to incorporate a going farm business leads logically to the decision to include all assets previously involved in the operation. But for others, there may be compelling reasons to incorporate only part of the assets.

Thus, it may be advantageous to:

- Incorporate the *operating side* of the farm business (e.g., livestock, machinery and equipment) and leave the land in individual, trust, or limited partnership ownership.
- Incorporate the land only and leave the operating side of the business in a partnership or sole proprietorship form.
- Form separate corporations for the operating assets and for the land.

The final decision on assets to include in a newly formed corporation depends on several key factors. There is no best way to handle it. Much depends upon the objectives of the individuals involved. Work closely with a tax consultant and attorney on this issue.

Other tax-related issues

In addition to the tax-related issues noted above, there are several others to be addressed:

- Will the corporation be formed and taxed as a regular C corporation or as a subchapter S corporation? With the C corporation, income is taxed at the corporate level, and any dividends declared will be taxed again at the shareholder level. With the S corporation, income is taxed at the shareholder level only.

- What will be the tax year for the corporation? Often, it is desirable to have a "short tax year" at the time of formation and then to have a corporate tax year that is different than the individuals' calendar tax year. (See Figure 7-1 and related text.)

- How to handle motor vehicles, residences and meals? Decisions need to be made as to whether the corporation should own motor vehicles and whether residences should be transferred to the corporation. Again, a tax consultant and attorney should be involved in the decision as there are liability and several tax-related issues to be addressed. Similarly, the issue of whether meals should be treated as a corporate expense needs to be addressed.

Employee-related issues/benefits

Several employee-related items need to be addressed. For example, consider employment contracts for employees, with special emphasis on sick leave, time off, annual vacation leave, employee benefits (such as group term life insurance, health and accident insurance coverage and retirement benefits), and workers' compensation coverage (providing specified benefits to insured employees). The corporation also must apply for a Federal Tax Identification number for income tax and social security purposes. The use of these benefits depends on whether a C corporation status is elected as opposed to an S status.

Actions taken at the first board of directors meeting

The corporation really gets underway at the first meeting of the board of directors. At that time, the officers are elected, salaries are set, and a bonus policy may be adopted. The board also accepts the property transferred to the corporation and issues stock and, perhaps, debt securities (notes, bonds or debentures) in exchange. (See earlier discussion of tax consequences of issuing debt securities.)

At its first meeting, the board also adopts bylaws for the corporation. The corporate bylaws are rules governing the internal conduct of the corporation. Included are such items as the time and place of shareholders and directors meetings, quorum requirements; a listing of officers and their duties; and miscellaneous provisions such as the fiscal year, the bank to be used, kinds of insurance to be carried, and special limitations on the authority of corporate officers to borrow money and to enter into contracts. And, if desired, the board can take action to elect taxation under Subchapter S (by which the shareholders, not the corporation, pay income tax on corporate income). The consent of each shareholder must be obtained along with the corporation's election on Form 2553. **The election for S status must occur within approximately two months after starting a business. Consult with an attorney**.

Action on other items discussed earlier in preparation for the meeting may also be in order.

Operating under the corporate structure[5]

When the appropriate state official issues a Certificate of Incorporation, the corporation becomes a legal entity and is in official existence. However, before actual operation of a corporate business entity commences, the rules of operation must be detailed in a set of *corporate bylaws*. **Liability issues** must be considered carefully as well to ensure that other corporate assets are protected under the corporate form of business.

The bylaws–some general comments/ division of authority[6]

The articles of incorporation are more permanent provisions than bylaws. They are placed on public file, thereby giving people outside the corporation notice of them. The **bylaws** are regulations of a less permanent nature and are not on file in a public office. However, **shareholders** are presumed to know their content and are bound by them. Bylaws provide general guides under which the business will be conducted, supplemented by resolutions of the **board of directors**, and daily management decisions of the **officers**.

State law usually provides that bylaws may contain any provision for the regulation and management of the affairs of the corporation not inconsistent with law or with the articles of incorporation. *The bylaws spell out the rights, duties, and responsibilities of the shareholders, directors, and officers of the corporation*. In a family farm corporation, the shareholders often act as directors, officers, and employees of the corporation. Thus, it is important that the separate functions of each group be kept in mind so that the actions that are taken can be in the proper capacity.

The farm corporation has the same operating decisions to make as does the farm partnership, the landlord and tenant, or the single owner/operator situations. A corporate management system, however, handles such problems in a slightly different way than they are handled in other types of business organizations. There are three different management groups in a corporation. *They are the shareholders, the directors, and the officers*. Each group has the power to authorize certain things and perform certain acts in the operation of the corporation. Since the shareholders are usually also the directors and the officers in a farm corporation, the same people will be performing the functions of all three groups. However, it is important to know the separate functions of each group so that each person will act in the proper capacity.

Ask an attorney for a listing of the rights, duties and responsibilities of a shareholder, director and officer. Understand these respective roles as well as the status as an employee of the corporation. The corporate structure is a very formal business arrangement. Failure to abide by these rules may cause the loss of the protection or advantages of the corporate structure.

Liability considerations: Doing things right

One of the general rules of corporate law is that the shareholders ordinarily are not personally liable for corporate obligations—neither contract-related or tort-related (negligence). For example, if a corporation has debts in excess of its assets, a creditor could not look to the individual shareholders for payment of corporate debts. This rule is in direct contrast to the partnership rule which makes partners individually liable for all debts and obligations of the partnership. This rule has been suggested as one of the advantages of operating as a corporate entity, and can be an advantage in some situations. **However, lenders to family-owned corporations ordinarily require that the shareholders co-sign for corporate debts, thus defeating any claim of limited liability relating to the repayment of these debts**.

5. See *Agricultural Law - Principles and Cases*, by J. W. Looney and Donald L. Uchtmann, McGraw-Hill, Inc., 1994, pp. 507, 508 and 516 for a more detailed discussion of the bylaws, including the duties and responsibilities of shareholders, directors and officers, as well as farm liability considerations.

6. Harl, *The Farm Corporation*

In the area of tort (negligence) law, the fact that the corporate structure offers limited liability can make the structure attractive to families—particularly those with nonfamily corporate employees. In situations where an employee causes injury or property damage while working, the corporation might be held liable. This responsibility would not extend to an individual shareholder's own assets.

Often, the owners of family-owned corporations fail to observe the legal formalities of doing business in the corporate form. They may ignore the fact that the corporation is a separate legal entity and may fail to distinguish between personal activities and those of the corporation. In such cases, the shareholders run the risk of losing limited liability protection for corporate obligations. Courts have, in appropriate cases, disregarded the corporate shield in order to prevent fraud. This has been applied in cases where abuse of the corporate privilege is obvious, where shareholders treat the corporate assets as their own, withdraw capital from the corporation, and fail to follow the formal corporate structure. The court may disregard the corporate shield in other situations where an obviously fraudulent or inequitable result would attain if the corporate form precluded personal liability.

Liquidating and reorganizing the corporation[7]

There may come a time when it becomes necessary or desirable to liquidate or reorganize a corporation.

Liquidations: The dissolution process

A corporation is dissolved when its existence is terminated, its charter extinguished, its affairs wound up, and its assets distributed among the creditors and shareholders. State statutes set forth procedures for dissolving a corporation. Dissolution may be voluntary by shareholder vote or involuntary. Income tax considerations are usually a major factor in planning for the liquidation of a farm corporation.

Details of dissolving a corporation by shareholder vote vary from state to state. Some states require a resolution of the board of directors approved by two-thirds of the shareholders. Unanimous written consent of the shareholders is frequently permitted for dissolving the corporation. In a few states, a shareholder may bring a court action for dissolution when management is deadlocked and the corporation is being injured as a result.

After dissolution is authorized, a report is filed with the Secretary of State, and the corporation must stop its business operations except for winding up its affairs. During the winding-up period, it is still a corporation. Notice of the intended dissolution must be given to each creditor. **Creditors have first call on the assets of the corporation as it is liquidated**. The articles of incorporation or other agreement may provide a liquidation preference among shareholders. If not, all shareholders share in the distribution of assets in proportion to their share holdings.

Most states provide for voluntary dissolution when the incorporators decide to back out before stock is issued and the corporation starts doing business. Formalities for completing such dissolution are much like those required for voluntary dissolution of an active corporation. Involuntary dissolution results from legal action against a corporation, usually by the Attorney General of the state. Failure to file reports or pay fees, fraud in obtaining the certificate of incorporation, or other violations of the law could result in state action against a corporation.

Liquidations: Income tax considerations

Liquidation may have important income tax implications for the shareholders. Through 1988, most small, closely held farm corporations were eligible for three different liquidation options, each with unique income

7. Prepared by Neil E. Harl, Professor of Economics, Iowa State University, and member of the Iowa Bar.

tax consequences. Effective in 1989, for most corporations gain or loss is recognized to a liquidating corporation on the distribution of property in complete liquidation *as if the property were sold to the recipient at its fair market value.*

The corporation also may have income tax liability from recapture of depreciation, recapture of soil and water conservation and land clearing expenses, recapture of excluded state and federal cost sharing payments, and disallowed deductions from unharvested crops.

Corporate reorganizations: A complex undertaking

As an alternative to corporate liquidation, shareholders may prefer one of several types of corporate reorganizations. For example, if the objective is to divide a farm business into two operating entities because of serious disagreements among the shareholders, a "divisive" reorganization might be a preferred choice. A divisive reorganization involves three major steps:

1. A new corporation is formed as a subsidiary of the old parent corporation.
2. Part of the parent corporation's assets are transferred to the newly formed subsidiary.
3. The stock in the subsidiary (held by the parent corporation) is distributed to some of the parent corporation's shareholders in exchange for their stock in the parent corporation.

As a result, one shareholder group ends up owning the subsidiary and its assets. Another shareholder group owns the parent corporation which has been reduced in size by the assets transferred to the subsidiary.

In general, divisive type reorganizations can be carried out tax-free to the corporation and the shareholders. Other types of reorganizations provide tax-free methods of purchasing stock or assets of another corporation. **Special note: However, shareholders must stay active in the corporation for a specified period of years in order to maintain the tax free spliting of the corporations.**

To discourage regularly-taxed corporations from electing S corporation status to minimize the income tax impacts of a corporate liquidation, a corporate-level tax is imposed on the appreciation of assets (referred to as "built-in gain") occurring prior to the S corporation election. The tax is imposed on appreciated assets disposed of within 10 years after the corporation becomes an S corporation. The tax imposed is the maximum corporate tax rate for the year in which the disposition occurs applied to the lesser of: (1) the recognized net built-in gains; or (2) the amount of taxable income if the corporation were not an S corporation. The corporate-level tax applies to all assets including inventory property. For S corporation elections before 1987, the corporate-level tax on built-in gains does not apply. Corporations electing S corporation status before 1989 can avoid the tax except as to built-in ordinary gain and short-term capital gains.

Obviously, the formation, operation and dissolution (or reorganization) of a farm corporation is a complex undertaking. It is important that one or more of the parties involved be willing to devote the time necessary to do things right. It is also a must to have a tax and legal support team in place to assist with every step.

Worksheet 7-1. Checklist for farm incorporation.[8]

1. **Name.** What is to be the corporation name? Consider application to reserve corporate name.

2. **Duration.** Will the corporation be organized to exist perpetually? Or for a term of years?

3. **Purpose.** What are the purposes of the corporation? Narrowly defined or broadly stated?

4. **Stock and debt capital structure.**

   a. How many classes of stock will be authorized? How many shares of stock will be issued? What are characteristics of each class as to:

   - Voting rights: voting stock, non-voting stock, proxy voting, cumulative rights.
   - Dividend rights.
   - Preference on liquidation.
   - Conversion rights, if any.
   - Par value (consider low par value to minimize annual fee on stated capital).
   - Fair market value on issuance.
   - Preemptive rights.

   b. Is debt capital to be used? (Watch tax-free incorporation limitation.)

   - Type of debt security (note, bond, debenture) and amount.
   - Time of maturity.
   - Conversion to stock.
   - Interest rate.
   - Priority on liquidation

   c. Is the corporation likely to be subject to the “freeze” rules enacted in 1990? If so, check the federal gift tax consequences of entering into property value freezes.

5. **Stock transfer restriction.** What type of restriction will be used (consent, first option, buy-sell agreement)? Method of stock valuation (book value, appraised value, periodically renegotiated fixed value)? Arrangements for payment by purchasers?

6. **Shareholders.** Names and addresses? Date of annual meeting? Place of annual meeting? Voting requirements? Quorum requirements? Pooling agreements? Voting trusts? Shareholders’ agreements? For minor shareholders (age-wise), consider using Uniform Gifts to Minors Act custodianship. Custodian should be someone other than donor.

7. **Board of directors.** Number of directors on board? Names of first directors? Voting requirements? Quorum requirements? Arrangements for meetings? Director fees? Is pre-incorporation agreement desirable?

8. **Officers.** What offices will be authorized? Who is expected to be elected to each office? What salary will be authorized for each officer? Is corporation to pay entire social security tax or only one-half? Will a bonus policy be authorized? What authority are officers to have in terms of borrowing money, signing negotiable instruments, executing contracts, or signing other documents? Explain proper format for signatures on corporate documents.

8. Prepared by Neil E. Harl, Professor of Economics, Iowa State University, and member of the Iowa Bar.

Worksheet 7-1 (continued). Checklist for farm incorporation.

9. **Other employees**. What individuals are to be employed by the corporation in addition to the officers? What are terms of employment? Is an employment contract to be drafted? Arrangements for compensation? Is corporation to pay entire social security tax or only one-half?

10. **Assets to be owned by corporation.** What property is to be transferred to the corporation?

    a. Prepare inventory for each transferor and list each by name of owner, description of asset, income tax basis, fair market value, indebtedness, and holding period. Preserve copies to be submitted with income tax returns. Watch gifts between and among transferrers of property, especially upon conveyance of property held in co-ownership. Any gift (to the other spouse) on conveyance to a corporation of property co-owned by a husband and wife is covered by the 100% federal gift tax marital deduction. Note insurance carried on assets and assets under special registration.

    b. Is transfer to be tax-free or taxable? Check eligibility requirements for one desired.

    c. Who will value assets?

    d. Have property taxes been paid by transferrers to date of incorporation?

    e. Documentary stamp taxes, state seal tax on land transferred if required?

    f. Abstracts of title?

    g. Prepare deeds and bills of sale.

11. **Assets to be leased by corporation.** What property will be leased to the corporation? List each item by name of lessor, description of property, and rental to be charged. Prepare leases.

12. **Bank.** Which bank will be the depository bank? Resolution of officer authority to borrow money and sign negotiable instruments should be prepared and sent to bank.

13. **Income taxation.** What method of income taxation will be followed?

    a. Regular. File form 1120 annually.

    b. Subchapter S. review eligibility requirements for election; prepare form 2553; if corporation has operated previously as regular corporation, check operating loss carryover, investment credit carryover, and recapture of investment credit. File form 1120-S annually.

14. **Identification number.** Prepare and submit form SS4, "Employer's Application for Identification Number."

15. **Registered office.** What is the address of the registered office of the corporation?

16. **Registered agent.** Who is to be the registered agent of the corporation?

17. **Notice of incorporation.** If required by state law, as in Minnesota, prepare notice of incorporation, forward to publisher of eligible newspaper and, where required, send affidavit of publication to secretary of state.

18. **Incorporation kit.** Order corporate kit, specifying type of seal, if any; number and type of stock certificates (have stock transfer restriction printed thereon or type restriction on certificate when received); minutes book.

Worksheet 7-1 (continued). Checklist for farm incorporation.

19. **Loans, mortgages.** What loans or mortgages are to be assumed or taken subject to by corporation? Give special attention to Federal Land Bank, Production Credit, Farm Service Agency loans.

20. **Basis.** Determine corporation's income tax basis of assets for purposes of depreciation and sale. Calculate and make a record of shareholders' basis for stock and securities received. Because of "galloping basis", repeat every year for Subchapter S corporations.

21. **Fiscal year.** What is to be the corporation's fiscal year? If fiscal year other than calendar year is considered for S corporations, check restrictions on selecting fiscal year.

22. **Method of accounting**. Is the corporation to be on the cash or accrual basis? Is the corporation required to be on accrual accounting by virtue of gross receipts, method of taxation and stock ownership? How are inventories to be valued?

23. **Special elections.** Check on elections for treatment of commodity credit loans, soil and water conservation expenses, and land clearing expenses.

24. **Residences.** Are houses to be transferred to corporation? Reasonable rental to be paid by occupants? Or are occupants to report value of occupancy as additional income? Or rely on I.R.C. §119?

25. **Motor vehicles.** What vehicles will be transferred to the corporation? Insurance arrangements? Title transfer? What vehicles will be individually owned? Rate of compensation for business use? Insurance coverage for accidents involving employee-owned vehicles within scope of employment?

26. **Recapture.** If corporation is not a mere change in form of doing business, will investment tax credit be recaptured? If the transfer of assets to the corporation is a taxable exchange, other amounts may be recaptured.

27. **Fringe benefits.** What fringe benefits are to be provided? Check health and accident plan, group term life insurance (10 or more employees or "baby group" plan), sick pay, and deferred compensation for retirement.

28. **Doing business in other states.** Will the corporation be doing business in another state? How much? Necessary to qualify to do business as a foreign corporation?

29. **Minorities.** Will stock be permitted to pass to off-farm shareholders? Consider assuring management rights, current income, and market for stock in planning for protection of minority shareholders.

30. **Wills**. Do wills and estate plans of shareholders need to be updated by codicil or completely rewritten? Consider provisions to direct executor to consent to Subchapter S election and to comply with restrictions on stock transfer. For holders or potential holders of Subchapter S of corporation stock, consider substitute provisions in lieu of trusts, e.g. Legal Life Estate rather than Marital Deduction Trust.

31. **Memberships.** What about memberships in cooperatives? Farm organizations? Breed associations?

32. **Insurance.** Check on casualty insurance, liability insurance, workers' compensation election, and motor vehicle liability.

Mid-career check of retirement and estate plans

8

- Assessing retirement lifestyle preparation
- Determining whether retirement income needs can be met
- Adjustment possibilities: The marginally adequate to inadequate financial situation
- Adjustment possibilities/concerns: The adequate to very adequate financial situation

The mid-career years of about ages 40 to 55 represent a critical period when preparing for retirement in three areas—finances, lifestyle and health. But even as one approaches the retirement years, there is still time to make at least some needed adjustments. This is a time to periodically test retirement lifestyle issues as well as check the likely adequacy of the anticipated financial situation in retirement. Also, have in place an estate plan just in case something happens.

The first section of this chapter discusses the process of assessing the adequacy of one's preparation for retirement lifestyle. It then lays out a procedure for determining whether one will be able to meet projected income needs. It then discusses possible adjustment concerns and strategies if: (1) the financial base is likely to be marginally adequate to inadequate; or (2) the financial base is likely to be adequate to very adequate in meeting retirement income needs. Estate planning aspects will also be discussed for each of these situations.

Assessing retirement lifestyle preparation

A meaningful, satisfying retirement lifestyle requires some thought and planning in a variety of areas:

- Home environment.
- Social life with family and friends.
- Future living arrangements–particularly if place of residence will change.
- How to make effective use of all that free time.

Allocate time between activities that engender feelings of **usefulness** and pure enjoyment. Begin now to develop "off-the-job" interests, e.g., hobbies, sports, travel. Will the "useful time" involve farming, a second career, or volunteerism? See Chapter 2, Part VI for a more detailed discussion of these lifestyle concerns.

Make note of any future potential demands on time or finances from within the family. Will there likely be an aging parent to care for? How might the career goals and/or special needs of children impact the situation? What is the current status of personal physical and mental health? What does current health portend for the future in terms of health care costs, its affect on lifestyle, and/or future earning power?

Determining whether retirement income needs can be met

The obvious next questions are: (1) is the proposed retirement lifestyle affordable? and (2) if not, what would it take in the way of future savings to make it happen? A relatively simplistic approach to answering these questions is presented here. The main goal is to prompt thinking about the financial aspects of retirement while there is still time to adjust. If some impending financial problems are anticipated, contact a financial consultant to help with a more detailed analysis of the situation.

Step #1. Determine current family spending and income balance; present net worth

Using Worksheet 8-1, estimate current living expenses. Next, using Worksheet 8-2, project current income. Then determine the projected balance between current income and expenses. If this analysis suggests an ability to meet current living expenses with income to spare, adjustments in current spending and savings patterns can be made if they are needed. When current spending equals or exceeds present income, however, it is a difficult financial situation, which will likely lead to continuing pressures being put on meeting retirement income needs.

Next, make an estimate of your current net worth, using Worksheet 8-3. Assets should be valued on a fair market value basis.

Step #2. Determine the net worth needed at retirement to meet projected retirement income needs

Using current spending as a guide (Worksheet 8-1), project the cost of the proposed retirement lifestyle in today's dollars. Then project the income expected from social security and other inflation-adjusted retirement plans in Worksheet 8-2. Total this income and subtract projected expenses.

If there is a projected income shortfall—and there is likely to be one since the income projection doesn't account for earnings from assets—determine the net worth needed at retirement to meet the projected income needs, using the procedures provided in Worksheet 8-3.

To make this analysis, first insert the retirement income shortfall from line 11 of Worksheet 8-2 at line 1 of Worksheet 8-4. Then insert the number of years you expect to have in retirement (line 2); the expected rate of return on investments (line 3); and the expected rate of inflation over the period (line 4). Then subtract line 4 from line 3 to determine the expected inflation-adjusted rate of return (line 5).

The example column of Worksheet 8-4 is based on the following assumptions: a retirement income shortfall of $20,000; 20 years in retirement; an expected investment return of 8%; and an inflation rate of 6%, leaving an inflation-adjusted rate of return of 2%. To determine the net worth needed by retirement, find the corresponding multiplier from Table 8-3. In the example, the factor for a 20 year retirement life span and a 2% inflation-adjusted return corresponds to a multiplier of 16.5. Multiplying the income shortfall ($20,000 in the example at line 1), by 16.5 at line 6, results in a net worth needed by retirement of $327,000. This is the amount needed if the last dollar of net worth and interest were spent on the last day of the twentieth year. Make a variety of assumptions using the three columns provided in Worksheet 8-4 to approximate the net worth needed at retirement.

Table 8-1 illustrates how sensitive the net worth amount needed at retirement is to the projected income shortfall, anticipated years in retirement, rate of return, and expected inflation rate. The table shows that, assuming a projected income shortfall of $15,000, ten years in retirement, and a 2% inflation adjusted return, the net worth needed at retirement is only about $90,000. At the other extreme, a $40,000 income shortfall, a 2% adjusted return, and 30 years in retirement, would require a 10 times larger net worth of $896,000.

Table 8-2, illustrates the monthly amount of funds that could be withdrawn from the asset base and have a balance of zero at the end of the stated number of years. It also indicates the amount of income that could be withdrawn each month if the principal were not used (the right hand column). Take note that this table is based on the assumption of an interest rate of 7% per year, compounded

Table 8-1. Impact of selected factors on the net worth needed at retirement.

Inflation adjusted return	Assumed return factor	Family spending shortfall		
		$15,000	$25,000	$40,000
		10 Years in retirement		
2%	8.98	$89,800	$224,500	$359,200
4%	8.11	81,100	202,750	324,400
6%	7.36	73,600	184,000	294,400
		20 Years in retirement		
2%	16.35	$163,500	$408,750	$654,000
4%	13.59	135,900	339,750	543,600
6%	11.47	114,700	286,750	458,800
		30 Years in retirement		
2%	22.40	$224,000	$560,000	$896,000
4%	17.29	172,900	432,250	691,600
6%	13.76	137,600	344,000	550,400

Table 8-2. Effect of initial retirement savings and life expectancy on maximum monthly withdrawal amounts.

Initial retirement savings:	Monthly withdrawal for the stated number of years, reducing the initial sum to zero:					Monthly withdrawal, while keeping the initial sum intact:
	10 yrs.	15 yrs.	20 yrs.	25 yrs.	30 yrs.	
$10,000	$116	$89	$77	$70	$66	$59
15,000	174	134	116	106	99	88
20,000	232	179	155	141	133	118
25,000	290	224	193	176	166	142
30,000	348	269	232	212	199	179
40,000	464	359	310	282	266	237
50,000	580	448	386	352	332	285
60,000	696	538	464	424	398	360
80,000	928	718	620	564	532	467
$100,000	$1,160	$896	$772	$704	$668	$585

Based on an interest rate of 7% per year, compounded quarterly.

quarterly. Also, the tax effects of liquidating these assets are not considered.

With the figures of Table 8-2 in mind, assume there is $100,000 of assets to liquidate (see bottom line of table). Assuming 10 years of retirement, one could withdraw $1,160 monthly. This is about double the $585 that could be withdrawn without affecting the $100,000 initial sum (see column at far right). If one expects to live 20 years, the amount is $772 per month, which is about 30% higher than if the principal remained in tact ($585). At 30 years, the monthly amount available drops to $668, which is only 15% higher than the $585.

Step #3. Determine additional annual savings needed to meet net worth goal at retirement

In phase #2 of Worksheet 8-4 (lines 8 through 15) make an estimate of the additional annual savings needed to meet the retirement net worth goal, line 7 of the worksheet. From Worksheet 8-3, insert the resultant net worth amount at line 8 of Worksheet 8-4. Then insert expected net inflation rate of return and the number of years until retirement. Then go to Table 8-4 for the appropriate multiplier estimated for determining *the future value of current net worth* at retirement.

The example assumes a current net worth of $200,000, a net inflation adjusted rate of return of 2%, and that the manager is 10 years *from* retirement. Multiplying the current net worth of $200,000 by the appropriate multiplier from Table 8-4 of 1.22, the projected value at retirement of this current net worth is $244,000 (line 12).

Subtracting this projected net worth at retirement (line 12) from the net worth needed at retirement (line 7), determines the net worth shortfall, which is recorded at line 13. (In the example, the net worth shortfall is $83,000.) Next, multiply this amount by the appropriate multiplier from Table 8-5 to determine the additional annual savings needed to meet the net worth goal at retirement. In the example, the multiplier is .091. Multiplying the $83,000 shortfall by .091 reveals that an additional annual savings of $7,500 is needed to meet the retirement net worth goal.

Of course, if the net worth amount at line 12 is greater than line 7, there should be sufficient net worth at retirement to meet income needs in retirement. Work through several situations in the columns provided to determine how sensitive a given situation is to the various assumptions made.

Some comments regarding the above analysis

- This analysis assumed that social security would be the only non-investment income available. If one has other inflation-adjusted income (e.g. pension plans), subtract that amount from the income shortfall as well (see Worksheet 8-2).

- This analysis is based on the use of multipliers that assume all assets will be used up by the time of the retiree's death or that of the spouse. If one desires to leave an estate to heirs, then use multipliers that reflect this desired outcome.

- The main purpose of the above discussion is to prompt thinking about one's present financial situation and ability to meet future retirement needs. **Now is a very appropriate time to work with a financial consultant regarding one's specific situation. There is still time to make selected adjustments in income and spending patterns to more adequately meet retirement goals.**

Conclusion: Overall assessment of retirement lifestyle and finances

Having completed the above assessment, one should be in a position to make an overall evaluation of the adequacy of preparation for retirement at this stage. In most cases, the key factor at this point is the projected adequacy of financial resources. If financial resources are likely to be **marginally adequate to inadequate** on the present course, determine if the financial situation can be improved to the point of meeting the cost of projected retirement lifestyle. If it is unlikely that the cost is manageable, then the desired retirement lifestyle will have to be changed and lifestyle preparation altered to fit the situation.

If one's financial resources are projected to be **adequate to very adequate** for meeting retirement needs and desires, focus on business and estate planning aspects, including protecting the financial situation as well as exploring the extent to which one could/should give greater assistance to children and their career development. Since finances will likely be more than adequate, spend the necessary time and money ensuring that retirement will be meaningful and satisfying. Spend the necessary time and money needed to maintain and enhance physical and mental health to the extent possible.

Adjustment possibilities: The marginally adequate to inadequate financial situation

If one's projected financial base in retirement is likely to be inadequate, several adjustment possibilities and/or concerns need to be explored. First, what are the opportunities for reconciling the financial/lifestyle situation? Second, what are some related lifestyle and health concerns that need to be addressed? And, lastly, will present estate transfer plans need to be developed or altered?

Reconciling financial base/lifestyle situation

The overriding strategy is to protect what one has and to not get involved in dealings that may only make the situation worse. That is, don't try to go out and make a "killing!", or win the lottery! There are three major alternative adjustment routes that might be explored:

1. Improve the financial base.
2. Alter the retirement plans/expectations.
3. Some combination of these two alternatives.

Improving financial situation

Evaluate the present business and project whether profits could be improved through improved production and/or marketing efficiency, dropping unprofitable enterprises, while possibly making a modest expansion of profitable ones. Rather than a major business change that might jeopardize one's financial situation even further, consider altering farming operations to allow the manager and/or spouse to work off the farm, or do custom work for other farmers. Explore ways of cutting back the current lifestyle and its associated costs. With these improvements in earnings and/or reduced living expenses, the retirement income picture should improve. One can either pay down debt or invest in tax-exempt/tax-deferred investments.

If a financial crisis has left the financial situation in shambles, seriously consider mediating the situation with lenders, and even going to the point of a reorganization under bankruptcy, or liquidating the present business, and starting over. Continuing to live with an impossible financial situation will only further jeopardize the retirement financial situation. To evaluate this type of option refer to Chapters 2, 3 and 5, Part I of this series.

Altering retirement plans/expectations

The other major adjustment route is to alter retirement lifestyle plans to better fit the projected financial situation. Consider scaling back retirement lifestyle—living arrangements, travel, and other activities. Also consider more work-for-pay activities during early retirement years. This may involve farming more actively and/or longer than originally planned or, developing a second career.

Some related lifestyle development and health concerns

Although a person's financial situation may affect retirement lifestyle negatively, financial concerns should not prevent adequate preparation for retirement lifestyle. It would be ironic (and a shame) if the financial position were to improve markedly by retirement time, but psychological preparation for retirement living had been neglected.

Maintaining and protecting one's health should be a prime concern since increased stress often accompanies attempts to improve a financial situation. If work is likely to be part of one's retirement years, health becomes of proportionately greaterer importance. Because of a relatively marginal financial position, protect against major health-related costs via the use of major medical and disability insurance policies.

Estate planning aspects

A key estate planning concern in a marginal financial situation is that the spouse be protected from the potential financial effects of the manager's disability or death. Having a will, with all property going to the spouse, is a must. Adequate health and life insurance programs

should also receive high priority. If there are still minor children involved, provide for a children's trust in the will as well as a designation of a preferred guardian for the children, in case something should happen to both parents.

By now, however, children should be well into their career preparation phase and possibly career development phase of life. With a marginal financial situation, be very cautious in terms of how much financial assistance is provided to the children at this stage. Remember, the best gift to children is an investment in their ability and capacity to earn their own way. Any investments of time, money and guidance a parent can give children during their career preparation/exploration stage will be very valuable and long remembered.

The next best gift a parent can provide children is giving them little reason to be concerned about parents' retirement years. If parents move toward having a busy, contented and reasonably self-sufficient retirement, the children should be very happy. This suggests that parents be more concerned with their own financial position in retirement, than with providing financial support for children as they launch their careers. If the farm business is not likely to continue after retirement, heirs can be treated on a relatively equal basis, with any transfer of assets to them occurring later in one's retirement years and/or at the time of the surviving spouse's death. Maintain an up-to-date will with the proceeds going to the surviving spouse.

Adjustment possibilities/concerns: The adequate to very adequate financial situation

If financial projections show an adequate financial base for retirement, one should feel very fortunate to be among a fairly select group of retirees who will enjoy such a desired situation. One's current and future retirement lifestyles should be relatively easily maintained and achieved. But three planning concerns should be explored:

1. Continued efforts to develop a meaningful lifestyle in retirement and the maintenance of health.
2. Protection of one's business/estate from undue risks and taxes.
3. Having an estate transfer plan in place which provides adequately for one's spouse, and fair treatment of heirs.

Continuing development of retirement lifestyle; health aspects

As indicated above, an ideal situation appears to exist for practicing various aspects of a retirement lifestyle. Finances will not restrict practicing and the business may be of a scale that will permit free time, since other members of the management team or work force can assume the manager's duties for a time.

In terms of using retirement for productive purposes, parents may have an ideal situation, in that the business operation may in fact be managed by one of the children. If parents "play their cards right," they may be able to "farm" as much and whenever desired—as long as they don't try to continue to "run the place."

Thus, one has an opportunity to adequately prepare for retirement–it's just a matter of doing it. Likewise, it is important to take good care of one's health, as it would be a shame to arrive at retirement with a great retirement lifestyle in place, plenty of money, and a health situation that doesn't permit one to do it and/or enjoy it.

Protecting the financial situation from undue risks and taxes

While it appears that one "has it made" financially, it is important to recognize that farming is a very dynamic, risky business. Many farmers who entered the 1980s "having it made" can attest to the fact that adverse economic conditions can devastate a substantial nest egg in a hurry. Therefore, monitor the business environment carefully, and protect the financial base through investment policies that may involve less risk and/or more diversification. Choose business/investment policies that better fit the uncertain future.

With a substantial financial base already, review estate planning from the standpoint of estate taxes, just in case something should happen unexpectedly. If combined (husband/wife) net worth exceeds one unified gift and estate tax credit, then explore ways of making maximum use of the unified tax credit that both husband and wife have. This may involve a marital gift to provide a more balanced estate (to avoid the order-of-death problem), and the use of a complex will that includes a so-called "credit" or "bypass" trust provision. If one's net worth totals well over a million, consider more intricate estate tools. For more on these financial risks and tax aspects, see Chapter 3, Part VI of this series. **Special Note**: **The 1997 Tax Act provides that the individual unified tax credit will be increased from $650,000 in 1999 to $1,000,000 by the year 2006. Beginning in 1999, the annual gift tax exclusion will be indexed for inflation.**

Estate transfer plans and treatment of children

There may well be internal, family-related threats to the financial/business situation as well. Parents are likely to be in a position to provide children with a good education and preparation for a career, as well as at least some financial support in their early-career development years. However, be careful not to indulge them to the point where the financial viability of the present business and, in turn, one's retirement financial picture is adversely affected. Obviously, with a broad continuum of financial situations possible, concerns and strategies for estate transfer vary.

Transfer strategies: The barely to somewhat-more-than-adequate financial situation

In this position, be cautious relative to the financial treatment of children—at least at this point. Considering the possibility of living another 30 years, don't overcommit finances at this point. Therefore, like in the "inadequate financial situation" discussed earlier, the overriding objectives are: (1) help children prepare for their work years, and (2) manage one's own financial affairs so a meaningful, satisfying lifestyle is possible, and parents are not a financial burden to children later on.

The extent of help offered to children beyond this depends on the adequacy of one's financial base and how large a subsidy will be needed to get them established in a career. The waters can get very muddy or threatening if one tries to bring one or more children into a farm business, particularly if it is too small at present. First, don't make major changes in the business that would tend to overly stress the present financial situation—at least early on. Second, be careful not to subsidize the heir's entry process too much. Remember, once gifts are made, their earning power has passed to that person, and thus, those earnings will not be there if or when a parent needs them in retirement.

For many farm families in this financial situation, a spin-off approach may be the better route. Here, the farming heir would trade some of his/her labor for the use of the parent's machinery. The farming heir would establish his/her own business. Over time, parents might co-sign a note, and eventually the farming heir may even assume control of the business upon the parent's retirement. See Chapter 4, Part V of this series for a more detailed discussion of these alternatives.

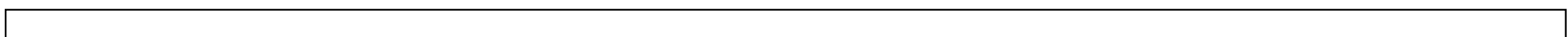
Transfer strategies: The very adequate financial situation; the fairness issue

In a very adequate financial position, subsidizing the early-career endeavors of children may not only be possible, but in many instances desirable, and in some instances, even necessary. For example, one of the problems with a very large farm business is that of being able to pass eventual control of the business to a farming heir(s).

Thus, early and continuing subsidies may be necessary for this to happen. Use of funded buy-sell agreements may also be among the strategies used. Because the estate is likely to be quite large, management of potential estate taxes may call for continuing use of the annual gift exclusion of $10,000 ($20,000 if spouse consents) per recipient each year. (Special note: this gift exclusion amount will be adjusted for inflation beginning in 1999.)

A yellow flag: First of all, don't be in too big a hurry to transfer major blocks of assets until the stability and managerial ability of farming children are proven. A business taken over by inept management can threaten parents' financial security. Second, as noted earlier, getting a farming heir started on the road to eventual control of a large business usually involves various types of financial subsidies—by the parents. This can lead to some severe fairness issues relative to the other heirs which, in turn, could lead to putting considerable stress on family relationships. This may necessitate plans to improve this fairness situation relative to the other heirs overtime.

For a more detailed discussion of the asset transfer process and options, see Chapter 4, Part VI of this series.



Worksheet 8-1. Estimating expected retirement living expenses.

	Average at present	Expected early years of retirement	Line
Committed expenses			
Household			
Real estate taxes	$____	$____	
Insurance: residence/personal property	____	____	
Utilities, phone	____	____	
Maintenance/upkeep	____	____	
____	____	____	
Food (at home)	____	____	
Clothing/cleaning	____	____	
Personal care	____	____	
Health care	____	____	
Drugs/doctors (uncovered amount)	____	____	
Health insurance	____	____	
Transportation	____	____	
License	____	____	
Insurance	____	____	
Fuel	____	____	
Repairs	____	____	
____	____	____	
Other committed expenses	____	____	
Life insurance	____	____	
Other insurance	____	____	
Dependent care	____	____	
Alimony, child support	____	____	
Total committed living expenses	$____	$____	1
Discretionary Expenses			
Home improvements	____	____	
Entertainment	____	____	
Dining out	____	____	
Recreation/hobbies	____	____	
Travel/education	____	____	
Gifts/contributions	____	____	
Savings/reinvest earnings	____	____	
____	____	____	
____	____	____	
Total discretionary living expenses	$____	$____	2
Total estimated living expenses (1 + 2)	____	____	3

Worksheet 8-2. Estimating expected retirement income; income/expense balance.

	Average at present	Expected early years of retirement	Line
Estimated income			
Income from business/investments			
Adjusted (net) business profits	$__________	$__________	
Adjusted (net) rental income	__________	__________	
Taxable dividends	__________	__________	
Taxable interest	__________	__________	
Nontaxable interest	__________	__________	
____________________	__________	__________	
____________________	__________	__________	
Total business/investment income	__________	__________	1
Nonbusiness/investment income			
Wages/salary self	$__________	$__________	
Wages/salary spouse	__________	__________	
Social Security income-self	__________	__________	
Social security income-spouse	__________	__________	
Retirement funds (Keogh, IRA, 401K)	__________	__________	
Contract for deed payments from others	__________	__________	
Income from annuities	__________	__________	
____________________	__________	__________	
Total nonbusiness/investment income	__________	__________	2
Total estimated income (1 + 2)	__________	__________	3
Income/expense balance			
Estimated federal/state income tax on above income	$__________	__________	4
Annual principal and interest payments due	__________	__________	5
Other financial commitments	__________	__________	6
Total estimated income available for living expenses (line 3 - (4 + 5 + 6))	$__________	$__________	7
Total committed living expenses (line 1, Worksheet 8-1)	__________	__________	8
Balance available for discretionary expenses (7 - 8)	$__________	$__________	9
Total discretionary expenses (line 2, Worksheet 8-2)	__________	__________	10
Balance - Surplus/(Deficit) (9 - 10)	$__________	$__________	11

Worksheet 8-3. Estimate present net worth/net estate using market value.

Date:

Assets	Husband	Wife	Jointly	Line
Liquid assets				
Checking accounts	$__________	$__________	$__________	
Savings accounts	__________	__________	__________	
Money market funds	__________	__________	__________	
Cash value, life insurance	__________	__________	__________	
____________________	__________	__________	__________	
Subtotal liquid assets	$__________	__________	__________	1
Farm assets (use current values)				
Crops and livestock	$__________	__________	__________	
Breeding stock	__________	__________	__________	
Machinery/equipment	__________	__________	__________	
Farmland	__________	__________	__________	
Buildings	__________	__________	__________	
Subtotal farm assets	$__________	$__________	$__________	2
Other investments				
Other personal property	$__________	$__________	$__________	
Other real estate	__________	__________	__________	
Bonds/bond mutual funds	__________	__________	__________	
Stocks/stock mutual funds	__________	__________	__________	
Annuities - fixed/variable	__________	__________	__________	
Retirement plans (IRA., Keogh, 401K)	__________	__________	__________	
____________________	__________	__________	__________	
____________________	__________	__________	__________	
Subtotal other assets	$__________	$__________	$__________	3
Other property				
Home furnishings, autos, etc.	$__________	$__________	$__________	
____________________	__________	__________	__________	
____________________	__________	__________	__________	
Subtotal other property	$__________	$__________	$__________	4
Total assets (1 + 2 + 3 + 4)	$__________	$__________	$__________	5
Liabilities				
Real estate debt	$__________	$__________	$__________	
Personal property debt	__________	__________	__________	
____________________	__________	__________	__________	
____________________	__________	__________	__________	
Total liabilities	$__________	$__________	$__________	6
Subtotal (5-6)	$__________	$__________	$__________	7
Allocation of joint property (from line 7)	__________	__________		8
Net worth/net estate (7 + 8)	$__________	$__________		9

Worksheet 8-4. Estimating additional annual savings needed to meet net worth goal at retirement.[1]

Phase 1. Estimating net worth needed at retirement to meet retirement income needs.

	Example	Expected	Worst case	Better case	Line
Retirement income annual shortfall (line 11, Worksheet 8-2)	$ 20,000	$	$	$	1
Expected years in retirement	20				2
Expected rate of return on investments	8%	%	%	%	3
Expected rate of inflation	6%	%	%	%	4
Net inflation adjusted rate of return (line 3-4)	2%	%	%	%	5
Multiplier factor from Table 8-3	16.35				6
Net worth needed by retirement (line 1 x 6)	$ 327,000	$	$	$	7

Phase 2. Estimating annual savings needed to meet net worth goal at retirement.

	Example	Expected	Worst case	Better case	Line
Current net worth (from Worksheet 8-3)	$ 200,000	$	$	$	8
Net inflation adjusted rate of return	2%	%	%	%	9
Years to retirement	10				10
Multiplier from Table 8-4	1.22				11
Projected future value of current net worth at retirement (line 8 x 11)	$ 244,000	$	$	$	12
Net worth shortfall, if any (line 7 - 13)	$ 83,000	$	$	$	13
Multiplier from Table 8-5	.091				14
Additional annual savings needed to reach net worth goal at retirement (line 13 x 14)	$ 7,500	$	$	$	15

1. This worksheet was adapted from *Taking Control Of Your Future - A Step-By-Step Guide To Planning For Retirement*, Fidelity Investment Co.

Table 8-3. Multiplier factors for estimating net worth needed at retirement.

Expected years in retirement	Inflation adjusted net return		
	2%	4%	6%
5	4.71	4.45	4.21
10	8.90	8.11	7.36
15	12.85	11.12	9.71
20	16.35	13.59	11.47
25	19.52	15.62	12.78
30	22.40	17.29	13.76

Example: If the assumed rate of return is 8% and inflation is expected to average 6%, net return is 2%. So go to the 2% column; go down to the number of years one expects to be in retirement. If the number of years in retirement is 25, the return factor is 19.52. Multiply this by the income stream needed. If one needs $11,000 each year for 25 years, multiply $11,000 times 19.52, which equals $214,720 net worth needed at retirement.

Table 8-4. Multiplier factors for estimating the future value of present net worth.

Years until retirement	Inflation adjusted net return		
	2%	4%	6%
5	1.10	1.22	1.34
10	1.22	1.48	1.79
15	1.35	1.80	2.40
20	1.49	2.19	3.03

Example: If the assumed rate of return is 8% and inflation is expected to average 6%, net return is 2%. So go to the 2% column; go down to the number of years until retirement. If the number of years until retirement is 20, the multiplier factor is 1.49. Multiply this by current savings. If present savings equals $250,000 to date, that would be worth $372,500 at retirement.

Table 8-5. Multiplier factors for estimating annual savings needed to meet retirement goal.

Years until retirement	Inflation adjusted net return		
	2%	4%	6%
5	.192	.184	.177
10	.091	.083	.075
15	.057	.049	.042
20	.041	.033	.027

Example: Assume there are 20 years until retirement, and the savings goal is $177,470 in today's dollars at the end of 20 years. Assume a rate of return of 8% and an inflation rate of 6%, then use a net inflation adjusted return figure of 2% (or 8% minus 6%). So, with 20 years until retirement, look in the 2% column to find the discount factor for 20 years (.041) and multiply this by $177,470 which is $7,276, the average annual savings required until retirement to meet the retirement goal.

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